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ABSTRACT

This update of a report originally issued in 1990 provides an overview of the federal tax rules as they pertain to different types of employee-benefit plans that are available to members of the National Education Association (NEA) through their employers. The report is based on the law in effect as of August 15, 1994. Section 1 examines retirement and savings plans, with a focus on deferred-compensation plans. It provides background information and describes the basic features and special rules applicable to deferred-compensation plans. Section 2 describes health, dependent-care assistance, and "cafeteria plans" including tax treatments, benefits, limitations and requirements, and uses. One table is included. (LMI)

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Federal Tax Rules

Relating to Benefit Plans for Public Education Employees

A Resource Guide

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NATIONAL EDUCATION ASSOCIATION
Research Division

Federal Tax Rules

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Federal Rules as of August 15, 1994

NATIONAL EDUCATION ASSOCIATION
Research Division

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INTRODUCTION

This report, which was originally issued in 1990, provides an overview of the federal tax rules relating to the different types of retirement plans, savings plans, health plans, and dependent care plans that are available to members of the National Education Association (NEA) through their employers—state or local governments. The report is intended to serve as an important first step in the consideration of the different types of employee benefit plans.

More than 90 percent of NEA members are covered by a type of retirement plan called a defined benefit pension plan, which provides a specific periodic benefit throughout an employee's retirement. This report describes how defined benefit pension plans work, what rules and restrictions apply, and what special tax advantages are available. The report also describes in the same manner several other types of retirement and savings plans that can function effectively either as a supplement to a defined benefit pension plan or as an employer's only plan.

Careful attention to the rules set forth in this report can result in very significant savings for NEA members. On July 12, 1990, shortly before this report was originally issued, the *Baltimore Sun* criticized the Baltimore city government in the following terms:

> City officials have failed to take advantage of an Internal Revenue Service provision that would allow the city to shield its teachers from federal taxes on employee contributions to pension plans. The result would be an extra $365 to $824 each year in take-home pay for city teachers.

The provision at issue is contained in Section 414(h) of the Internal Revenue Code and is commonly referred to as the "pick-up" rule.

Just recently, the Delaware legislature, due to the efforts of the Delaware State Education Association, has passed a law to take advantage of the pick-up rule.

The pick-up rule is just one example that the more NEA members understand about the rules, the better their benefits will be and the greater their tax savings will be. In addition, an understanding of these rules can help members identify potentially harmful proposals to modify the law at either the federal or state level. Informed members acting together can make a difference in how new rules are shaped.

Knowledge of the rules summarized in this report can also prevent retirement plans maintained for NEA members from violating Internal Revenue Service (IRS) requirements that must be satisfied to avoid adverse tax consequences. According to the *Daily Tax Report* published by the Bureau of National Affairs, Inc., the IRS conducted a two-year investigation of Rhode Island's pension plan and found violations of the "exclusive benefit rule" and of Section 415 of the Internal Revenue Code. Because of these violations, the state has reportedly been subjected to certain sanctions. On March 3, 1994, the *Daily Tax Report* reported that according to an official in the Rhode Island General Treasurer's office, "following the agreement, IRS wrote all state pension funds in the Northeast to highlight key IRS code requirements and their compliance with those requirements."

Other employee benefits issues have also attracted IRS attention recently. On June 2, 1994, the *Daily Tax Report* stated:

> IRS considers defective Section 403(b) annuities as "one of the hottest issues in deferred compensation" because of the degree of non-compliance with the tax

> code [said Evelyn Petschek, who is the Director of the IRS' Employee Plans Technical and Actuarial Division].

On May 10, 1994, the *Daily Tax Report* suggested that the focus on Section 403(b) plans has generally been restricted to plans maintained by private tax-exempt employers but that may change:

> Given the compliance problems that have surfaced in the exempt sector, particularly in the area of tax-deferred annuities, similar problems could exist in the public school sector as well, [James] McGovern said, suggesting that public schools may be next [sic] target of IRS audits of Section 403(b) arrangements.

James McGovern is the IRS Assistant Commissioner for Employee Plans and Exempt Organizations.

Employee benefit plans maintained by public employers in which NEA members participate are exempt from many rules applicable to employee benefit plans maintained by private employers (though such exemptions generally would not be helpful with respect to the issues described above as being raised by the IRS). In addition, plans that are the product of collective bargaining, as is the case with some plans for NEA members, receive further special treatment. This report incorporates the applicable exemptions and special rules.

This report is based on the law in effect on August 15, 1994. The law with respect to employee benefit plans has been modified numerous times in the past and it is anticipated that modifications will continue. Accordingly, it is imperative that NEA members seek further guidance before making any final decisions. In some cases, this report makes reference to proposed legislation that would affect a subject being discussed.

RETIREMENT AND SAVINGS PLANS

Background

Deferred Compensation Plans in General

The retirement and savings plans discussed below are all forms of "deferred compensation plans." Under a deferred compensation plan, the employees receive in subsequent years certain compensation earned currently.

Under certain types of plans, the decision whether to receive compensation currently or in a subsequent year is made by each employee. These types of plans are referred to in this report as "elective plans." Under other types of plans, the amount of deferred compensation provided with respect to any employee is determined under a formula that no individual employee can alter. These types of plans are referred to as "nonelective plans." There are also hybrid plans that combine both elective and nonelective features.

Retirement Plans vs. Savings Plans

Deferred compensation plans can be used for one of two purposes. First, a deferred compensation plan can provide an individual with income replacement after he or she has retired. Second, a deferred compensation plan can provide an individual with a means to save money for preretirement purposes (such as buying a home).

All of the deferred compensation plans described below can be used to provide retirement income. Certain plans are more effective in this regard than others.

Some, but not all, of the plans described below can be used as preretirement savings plans. However, certain aspects of the law concerning the availability of plan assets for distribution undermine the effectiveness of these plans as preretirement savings plans.

Qualified Plans vs. Nonqualified Plans

Deferred compensation plans are often referred to as "qualified" or "nonqualified."[1] In general, only defined benefit pension plans and defined contribution plans, both of which are described below, are qualified plans. A qualified plan is required to satisfy certain technical requirements, which vary depending on the type of qualified plan. Satisfaction of these requirements entitles the plan and the employees benefiting under the plan to certain favorable tax treatment, which is also described below. In addition, under a qualified plan, an employee's deferred compensation is not held by the employer but is made more secure by placement in, for example, a trust or annuity contract.

Nonqualified plans are not required to satisfy the technical requirements applicable to qualified plans. Accordingly, they are not entitled to the same favorable tax treatment. However, if a nonqualified plan meets certain less restrictive requirements, the plan and the employees enjoy certain tax advantages. These tax advantages do not apply, however, unless the employer holds the deferred compensation, subject to the employer's creditors.

In addition, there are two types of deferred compensation plans that are commonly viewed as neither qualified nor nonqualified: tax-sheltered annuity plans ("Section 403(b) plans") and simplified employee pensions (SEPs). Because

[1] *Although the use of the terms "qualified" and "nonqualified" is widespread, they are not technical terms. Accordingly, they are used by different people to mean different things. This report describes the most common usage of the terms, but it is recommended that more specific terminology be used in contract negotiations to avoid misunderstandings.*

these plans generally resemble qualified plans with respect to the aspects discussed above, they are referred to in this report as qualified plans.

Organization of Retirement and Savings Plan Discussion

This report describes the basic features of the five main types of deferred compensation plans: (1) defined benefit pension plans, (2) defined contribution plans, (3) Section 403(b) plans, (4) simplified employee pensions, and (5) nonqualified deferred compensation plans ("Section 457 plans"). In addition, the report discusses how certain plans--age-weighted plans, cash balance plans, and floor-offset plans—that are often referred to as separate types fit within the five main categories described above. The report also summarizes the special rules applicable to deferred compensation plans, including the requirements applicable to each type of plan and the tax treatment of distributions from each.

Deferred Compensation Plans for NEA Members

The NEA 1992 Benefits Survey shows that at least 99.3 percent of the respondents have some type of deferred compensation plan available to them and at least 96.4 percent of the respondents participate in such a plan. Substantially all of these 96.4 percent participate in a defined benefit pension plan. In addition, the survey indicates that 85.1 percent of the respondents are eligible to participate in a second plan and that 49.9 percent of all respondents participate in such a plan. The survey refers to such second plans as "supplemental plans" and notes that Section 403(b) plans and Section 457 plans are examples of such supplemental plans.

Basic Features of Deferred Compensation Plans

Defined Benefit Pension Plans

A defined benefit pension plan is a qualified plan under Section 401(a) of the Internal Revenue Code. Under a defined benefit pension plan, employees earn, during their career with the employer, the right to a specified amount of pension payments each year during retirement.

For example, a defined benefit pension plan might provide that for each year that employees work for an employer, they earn 1 percent of their "final average compensation." Final average compensation could be defined as the average compensation earned during the last five years of employment. Thus, assume that an employee starts work for an employer at age 35 and retires at age 65. Assume further that such employee's average compensation during the last five years of employment was $35,000. Under the plan described above, this employee would be entitled to an annual pension payment of 30 x .01 x $35,000 = $10,500. (The "30" represents years of service; the ".01" is the 1 percent per year of service; and the $35,000 is final average compensation.) Thus, starting at age 65, this employee would receive $10,500 every year until death; typically the payments would be made on a monthly basis. (For discussion purposes, it is assumed that the employees are 100 percent vested in the benefits they have earned. Plans may, of course, impose certain requirements, such as minimum service requirements, in order for an employee to be 100 percent vested. Rules regarding vesting are discussed below.)

Source of payments

The payments made to employees under a defined benefit pension plan are typically made from a trust. The employer makes contributions to this trust as the employees are working so that when the employees retire there is enough money in the trust to make the pension payments.

In general, until all benefits earned by employees have been paid to the employees (or their beneficiaries), the trust assets may only be used to make such payments or to pay administrative expenses incurred by the plan. (Administrative expenses may also be paid directly by the employer; whether the employer or the trust makes these payments is generally determined pursuant to the plan or trust document.) Under certain circumstances, assets in excess of the amount needed to provide employees with their benefits (or to pay administrative expenses, if applicable) may revert to the employer. See "Special Rule—Miscellaneous" below.

Elective plans vs. nonelective plans

A defined benefit pension plan can be structured either as an elective plan or a nonelective plan. The plan described above is a nonelective plan. The benefit provided to any employee depends solely on the application of the pension formula; employees may not make any elections that affect the application of the formula.

The plan could be made into an elective plan by requiring that employees, as a condition of being in the plan in any year, contribute, for example, 1 percent of their compensation to the trust. If each employee is permitted to decide whether or not to make a contribution, then the plan is elective and any contribution made by an employee is an "after-tax" contribution.

For example, assume that employees are entitled to a salary of $30,000. In order to participate in the elective plan described above, the employees must elect to contribute 1 percent of $30,000, i.e., $300. That $300 would be an after-tax contribution. In other words, although the $300 would be deducted from their paychecks, they would still be taxed as though they had received the full $30,000. It is as though they received the $30,000 and then made a nondeductible contribution of $300 to the trust.

A plan may be nonelective even though employee contributions are required as a condition of participation in the plan. For example, the employee contributions could be required as a condition of employment. Generally, such employee contributions would also be after-tax contributions. However, there is a special rule that applies with respect to employee contributions if, in general, employees do not have the right to receive the amount of the contribution directly, instead of having the amount contributed to the plan. Under this special rule, which is contained in Section 414(h) of the Internal Revenue Code, the employer may choose to "pick-up" the employee contribution. The result of the employer picking up the employee contribution is that, for federal income tax purposes, the contributions cease to be after-tax employee contributions and become "pretax" *employer* contributions.[2]

For example, assume that the same $30,000-a-year employees described above are covered under a "condition of employment" plan. Assume further that the employer picks up the $300 contribution. Under a common pick-up arrangement, everything is the same as described

In certain circumstances, an alternative means of having nonelective employee contributions made on a pretax basis is simply to designate them as employer contributions. This concept also applies to other types of qualified plans.

in the prior example except that the employees are only taxed on $29,700. In other words, the employer does not make any extra contributions and the employees have the same $300 deducted from their paychecks, but they are taxed as if they did not receive that $300.

Aside from elective and nonelective plans, there can also be hybrid plans under which a certain benefit is provided to all eligible employees on a nonelective basis, but higher benefits are only available if an employee makes an elective contribution to the trust.

The NEA 1992 Benefits Survey provides certain data regarding employee contributions to defined benefit pension plans.[3] The survey generally shows that, based solely on employees who made contributions to their defined benefit pension plans, the average employee contribution was 5.2 percent of compensation. The survey does not distinguish between elective and nonelective plans.

Form of payment

A common form of payment under a defined benefit pension plan is a life annuity, that is, a set amount per year starting at retirement and continuing until the employee's death.

One common variation would be a joint and survivor annuity based on the lives of the employees and their beneficiaries. Such an annuity might operate in the same manner as a life annuity during the employees' lifetime, then provide a second life annuity to the employees' beneficiaries. The second life annuity might be equal in annual payments to the employees' life annuity or it may be a percentage of the employees' life annuity. For example, employees might receive $10,000 a year during their retirement and their beneficiary might receive half that amount ($5,000) a year during the period between the employee's death and the beneficiary's death. Employees whose benefits are paid in the form of a joint and survivor annuity generally receive less during their lifetime than do employees who receive an annuity only for their own life.

Another common form of payment is a life annuity with a "term certain." Under such an annuity, payments for a specified number of years (the term certain) are made even if the employees and their beneficiaries die before that point (with the extra payments made to contingent beneficiaries).

The amount paid annually under the annuities described above may be subject to cost-of-living adjustments (COLAs). Such COLAs may be automatic, ad hoc, or contingent on specified events (such as trust earnings).

A defined benefit pension plan may also allow an employee to choose to receive, instead of an annuity, a single lump sum payment equal to the present value of the available annuity payments. In fact, a plan might require an employee to receive a lump sum payment at least under certain circumstances, for example, if the employee terminates employment prior to retirement age with a small vested benefit under the plan.

A defined benefit pension plan may also provide a combination of an annuity and a lump sum payment. For example, a plan may permit employees to choose to receive the benefit attributable to their own employee contributions in a lump sum and to receive their benefit derived from employer contributions in an annuity form.

[3] The survey does not actually refer to defined benefit pension plans, but rather refers to "basic plans" (as opposed to "supplemental plans"). However, since the basic plan for substantially all NEA members is a defined benefit pension plan, the survey data are provided here with respect to defined benefit pension plans.

The forms of distribution described above are among the more common ones.

General tax treatment

Employees are not taxed when employer contributions are made to a trust under a defined benefit pension plan. A distribution from the trust is taxable income to the recipient, however, except to the extent that the distribution is "rolled over" or is considered to be a return of the employee's after-tax contributions.

Subsequent sections of this report provide further guidance with respect to (1) deferring taxation of a distribution by rolling over the distribution into certain other deferred compensation plans or into an individual retirement account (IRA); (2) determining the portion of any distribution that consists of an employee's after-tax contributions; (3) penalty taxes that apply to certain distributions; and (4) special means of reducing the rate at which a distribution is taxed.

In general, neither contributions (other than after-tax contributions) to the trust nor distributions from it are subject to the Social Security tax (even if such tax generally applies to an NEA member).[4] However, a pick-up contribution is subject to the Social Security tax (if such tax generally applies) to the extent that the contribution is made pursuant to a salary reduction agreement. For this purpose, a salary reduction agreement need not be in writing. Trust earnings are generally exempt from taxation.

Defined Contribution Plans

Like a defined benefit pension plan, a defined contribution plan is a qualified plan under Section 401(a) of the Internal Revenue Code. However, under a defined contribution plan, each participating employee has an account in the plan. Contributions are made to that account by the employer and/or by the employee. The earnings attributable to those contributions are also credited to the employee's account. Thus, defined contribution plans function like bank accounts.

The primary difference between a defined contribution plan and a defined benefit pension plan is that in the former the employer only commits to a certain level of contributions. Accordingly, unlike a defined benefit pension plan, the amount of assets available to the employee for retirement (or preretirement purposes) is, in all cases, solely a function of the contributions to the trust and the earnings generated by those contributions.

There are two types of defined contribution plans that are relevant for NEA members: money purchase pension plans and profit-sharing plans. Until the Tax Reform Act of 1986, there was some question as to whether a public employer could maintain a profit-sharing plan since it did not have profits in the traditional sense. The Tax Reform Act of 1986 provided, however, that an employer could maintain a profit-sharing plan even if it did not have profits. In effect, although the name "profit-sharing plan" remained, the existence of profits became irrelevant. Accordingly, it became clear that public employers could maintain a profit-sharing plan.

Although private employers typically retain discretion on a year-to-year basis as to whether to make a contribution to a profit-sharing plan, that is not a necessary component of a profit-sharing plan. An employer can be required under a profit-sharing plan (or a collective bargaining agreement) to make a specified level of contributions to a profit-sharing plan.

[4] *References in this report to the Social Security tax include the hospital insurance tax as well as the old-age survivors, and disability insurance tax.*

Accordingly, there are few differences for NEA members between money purchase pension plans and profit-sharing plans. In fact, the differences that do exist favor the adoption of a profit-sharing plan. Except as specifically noted, the discussions below of defined contribution plans apply both to money purchase pension plans and to profit-sharing plans.

Although the term "profit-sharing plan" is the term used in the Internal Revenue Code, an employer that adopts a profit-sharing plan has discretion with respect to whether to include the term in the actual name of the plan. For example, a public employer that finds the term inappropriate might refer to a profit-sharing plan as a retirement plan, a supplemental retirement plan, or a savings plan.

Source of payments

The payment source is the same as in defined benefit pension plans described above, except that in almost all cases, all employer and employee contributions (and the income earned by such contributions) are allocated to employees' accounts and are thus payable to the employees (or their beneficiaries) (net of the administrative expenses charged to the plan). However, employees are not entitled to more than that amount unless the employer has failed to make required contributions.

Elective plans vs. nonelective plans

A defined contribution plan may be structured as an elective plan, a nonelective plan, or a hybrid. An example of a nonelective plan would be a plan under which the employer contributes on behalf of each eligible employee an amount equal to 5 percent of such employee's compensation.

The following is an example of an elective plan. Under the plan, employees may elect whether to contribute to the trust any amount up to 3 percent of their compensation. In addition, for every dollar contributed by the employee, the employer will also contribute a dollar (or a different figure, such as fifty cents or two dollars). The employee may also have the option of making additional contributions to the plan that are not "matched" by the employer. Alternatively, a plan may be structured so that an employee may elect whether to make contributions, but none of such contributions are matched by the employer.

In general, employee contributions to a defined contribution plan must be after-tax contributions. In order for an employee contribution to be made on a pretax basis, it must either (1) be made under a pick-up arrangement, which is nonelective as described above (in which case the contribution is treated as an employer contribution) or (2) be made under a special type of elective plan commonly referred to as a "401(k) plan."

The general rule, however, is that a state or local government may not maintain a 401(k) plan. Under an exception to this rule, a state or local government that had adopted a 401(k) plan before May 6, 1986, may maintain a 401(k) plan on behalf of any of its employees, including employees not covered before May 6, 1986.

Forms of payment

Payments made from a defined contribution plan may be made in the same forms described above with respect to defined benefit pension plans. However, lump-sum payments are more common with respect to defined contribution plans. In addition, installment payments made over a specified number of years are not uncommon in defined contribution plans. If a defined contribution plan does make a distribution in an annuity form, it is done by using the employee's account to purchase an annuity contract from an insurance company.

General tax treatment

The tax treatment of defined contribution plans is the same as with defined benefit pension plans described above, except that pretax employee contributions under a 401(k) plan are subject to the Social Security tax (if otherwise applicable).

Section 403(b) Plans

All Section 403(b) plans are structured either as defined benefit pension plans or defined contribution plans. The reason that Section 403(b) plans merit separate discussion in this report is that Section 403(b) plans are subject to their own special rules. (Section 403(b) plans may only be maintained by an employer that is either a public educational organization or a certain type of private nonprofit organization.)

This report discusses Section 403(b) plans in the context of defined contribution plans. This is done primarily because Section 403(b) plans are much more frequently structured as such. The rules outlined with respect to defined contribution Section 403(b) plans, however, generally also apply to defined benefit Section 403(b) plans.

Source of payments

In general, contributions by an employer or employee under a Section 403(b) plan must be either (1) used to purchase an annuity contract for the employee or (2) paid into a custodial account[5] and invested in regulated investment company stock (that is, mutual funds) on behalf of the employee. (Thus, there is no trust.) Both arrangements function like a defined contribution plan: the employee is entitled to the contributions and to the earnings attributable to those contributions that are generated by the annuity contract or custodial account.

Elective plans vs. nonelective plans

The discussion above of elective and nonelective defined contribution plans applies to Section 403(b) plans with two important exceptions. First, employee contributions under a Section 403(b) plan may be made on a pretax basis regardless of whether they are elective or nonelective. In fact, elective pretax employee contributions are the most common form of contribution under a Section 403(b) plan. Second, the pick-up rules do not apply.

The NEA 1992 Benefits Survey provides information regarding employer and employee contributions to supplemental plans, which appear to be predominantly Section 403(b) plans and Section 457 plans, but which may also include some defined contribution plans. The survey shows that the average employee contribution made by respondents contributing to their supplemental plan was 5.3 percent of compensation. Respondents participating in supplemental plans estimated that the average employer contribution was 1.3 percent of compensation.

Forms of payment

Benefit payments made under a Section 403(b) plan are the same as defined contribution plans described above.

A custodial account is generally an account established with a bank or similar institution in which Section 403(b) funds may be held.

General tax treatment

The tax treatment of 403(b) plans is the same as defined benefit pension plans described above, except that (1) the special means of reducing the tax rate applicable to a distribution do not apply, (2) pretax employee contributions are subject to the Social Security tax (if otherwise applicable), and (3) as noted, the pick-up rules do not apply.

Simplified Employee Pensions (SEPs)

A SEP is, in effect, a special type of defined contribution plan that is established under Section 408(k) of the Internal Revenue Code. Under a SEP, the employer makes contributions to IRAs established on behalf of all the eligible employees.

Source of payments

Under a SEP, all payments to employees (or their beneficiaries) are made from the employee's IRA.

Nonelective plan

Only nonelective employer contributions may be made to a SEP maintained by a state or local government.

Forms of payment

Benefit payments under a SEP are made in the same form as defined contribution plans described above.

General tax treatment

The tax treatment of contributions to and distributions from a SEP is the same as defined benefit pension plans described above, except that (1) the special means of reducing the tax rate applicable to a distribution do not apply, and (2) the rules relating to employee contributions do not apply because there are no employee contributions.

Section 457 Plans

In general, deferred compensation plans that do not "qualify" as defined benefit pension plans, defined contribution plans, Section 403(b) plans, or SEPs are nonqualified deferred compensation plans. (The basic standards that deferred compensation plans must satisfy to "qualify" are discussed below under "Special Rules.") Nonqualified deferred compensation plans fall into two categories: Section 457(a) plans and Section 457(f) plans. The difference between the two categories is that Section 457(a) plans meet certain requirements and thereby qualify for more favorable tax treatment.

Section 457(f) plans essentially include any deferred compensation plan maintained by a state or local government that does not (1) qualify as a Section 457(a) plan, (2) fall within one of the other categories of plans described above, or (3) fit within certain narrow exceptions.[6] The tax treatment of Section 457(f) plans is generally unfavorable. The primary unfavorable aspect is that employees are generally taxed on the deferred compensation provided under a Section 457(f) plan when their rights to such compensation become substantially vested, even though they may not at that time have received the

[6] *There are exceptions for bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plans. There are also certain transition rules for certain plans in existence in 1987 or 1988.*

deferred compensation in current cash. Because of the unfavorable treatment of Section 457(f) plans, this report does not discuss these plans further and references to deferred compensation plans are intended to be references to plans other than Section 457(f) plans.

Although Section 457(a) plans can be structured either like defined benefit pension plans or defined contribution plans, the latter are much more common and, accordingly, this report discusses Section 457(a) plans in that context. (The rules outlined with respect to defined contribution Section 457(a) plans generally also apply to defined benefit Section 457(a) plans.)

Source of payments

Under a Section 457(a) plan, the employer simply promises to make certain payments to employees at a subsequent time. There may or may not be a trust, annuity contract, or custodial account to which contributions are made. Even if a trust, etc., is established, the assets placed in the trust may not be restricted to make payments under the Section 457(a) plan, but rather must be available to the employer's general creditors.

The absence of a trust does not mean that an employee is not credited with contributions and earnings on those contributions. Contributions on behalf of an employee, whether made by the employer or the employee, are credited to the employee and are generally held by the employer as part of its general assets. The employee is also credited with earnings based either on a stated rate of return established by the employer (such as 6 percent) or based on the actual rate of return earned by the employer with respect to investments made with the employee's deferred compensation.

Elective or nonelective plan

A Section 457(a) plan may be elective, nonelective, or a hybrid, as in the case of a defined contribution plan. However, most typically it is a purely elective plan, that is, only elective employee contributions are made. Although it is unclear whether after-tax employee contributions to a Section 457(a) plan are permitted, the issue is moot because all employee contributions to such a plan can and should be made on a pretax basis.

Form of payment

Benefit payments under a 457(a) plan are made in the same way as in the defined contribution plans described above.

General tax treatment

The tax treatment of contributions to and distributions from a 457(a) plan are the same as in the defined benefit pension plans described above, except that (1) all distributions from a Section 457(a) plan are taxable (because there are no after-tax employee contributions or rollovers); (2) under certain circumstances, an employee who has a right to receive a distribution from a Section 457(a) plan upon demand is taxable on the amount available, even if not distributed; (3) Section 457(a) plans are not subject to the penalty taxes, special lower tax rates, or pick-up rules applicable to defined benefit pension plans; and (4) a contribution to a Section 457(a) plan is subject to the Social Security tax (if otherwise applicable) when the contribution is vested.

Special Types of Plans

The terminology used with respect to deferred compensation plans is often a source of confusion. For example, there are certain plans that are often referred to as separate types of plans but actually fit within one of the five categories listed above.

Age-weighted plans

There has been considerable publicity recently regarding "age-weighted plans." In almost all cases, these plans are nonelective defined contribution plans or Section 403(b) plans. (Age-weighted plans are discussed below in the context of defined contribution plans rather than Section 403(b) plans; this is done for convenience of presentation since the same principles apply in both cases.) What is distinctive about an age-weighted plan is the way contributions are allocated among the employees.

Under a conventional nonelective defined contribution plan, each employee's account is credited with the same employer contribution, measured as a percentage of the employee's compensation. For example, each employee might be credited with a contribution equal to 5 percent of such employee's compensation. Under a common variation, the percent of compensation may increase with respect to compensation in excess of the Social Security wage base.

Under one type of age-weighted plan, the employer's nonelective contribution is allocated among employees based on a formula that takes into account both age and compensation, with the older employees receiving much larger contributions (again measured as a percentage of compensation). For example, younger employees might receive contributions equal to 3 percent of compensation while older employees are credited with 15 percent or more.

The formula that determines how much the different employees are credited with is derived from the IRS's nondiscrimination rules, which are discussed below under "Special Rules." These rules establish a special method of nondiscrimination testing—referred to as "cross-testing"—under which small contributions for younger employees can be considered to be equivalent to larger contributions for older employees. Under this special rule, the contributions are "cross-tested" based on the life annuity that could be purchased for the employee at normal retirement age. For younger employees, a contribution has many more years prior to normal retirement age in which to earn income. Accordingly, a very small contribution for a 25-year-old and a very large contribution for a 64-year-old could purchase the same life annuity starting at age 65 and thus would be considered equivalent for purposes of the nondiscrimination rules.

Many private employers find cross-testing to be attractive because it allows them to provide their older employees—who are often more highly compensated—with larger retirement benefits without running afoul of the nondiscrimination rules.[7] Generally, this same favoring of older employees could be achieved through a defined benefit pension plan, since defined benefit plan benefits are generally expressed as life annuities starting at normal retirement age. However, many private employers, particularly small ones, find the administrative costs and burdens of defined benefit pension plans to be prohibitive.

The nondiscrimination rules generally have little effect on defined contribution plans maintained for NEA members. Moreover, there is generally no desire to favor higher paid NEA members over lower paid NEA members.

The Treasury Department has proposed legislation to curb the use of cross-testing to satisfy the nondiscrimination rules. As of August 15, 1994, no such legislation has been enacted.

Accordingly, the primary rationale for NEA members to seek coverage under an age-weighted plan is to provide larger contributions to older employees, not because they tend to be highly compensated employees but because they are closer to retirement.

Cash balance plans

Cash balance plans, which were generally created in the 1980s, are defined benefit pension plans. What is distinctive about cash balance plans is the benefit formula.

As discussed above, defined benefit pension plans often use benefit formulas that provide a set percentage of an employee's "final average compensation" multiplied by the employee's years of service. For example, a defined benefit pension plan might provide a benefit equal to 1 percent of final average compensation multiplied by an employee's number of years of service.

A cash balance plan, on the other hand, has a benefit formula that resembles the formula of a defined contribution plan. A cash balance plan generally provides that each employee is to have a hypothetical account within the plan. The employee's account will be credited with a deemed contribution each year, such as 5 percent of the employee's compensation. (The deemed contribution could also be age-weighted or varied in any other way used with respect to defined contribution plans.) In addition, the account balance will be credited with interest at a stated rate.

At first blush, cash balance plans seem more like defined contribution plans than defined benefit pension plans. There are, however, critical factors that make them defined benefit pension plans. The key factor is that there is a guaranteed interest rate. Thus, even if the plan's actual assets sustain a loss, each employee's hypothetical account will still be credited with the stated interest rate. This element alone is technically sufficient to make the plan a defined benefit pension plan. Another important aspect of a cash balance plan is that the employer is not required to make annual contributions equal to the deemed contributions. The employer may choose, within certain limits, to overfund or underfund the plan for a period of time, provided that there should be sufficient assets in the plan in order to pay the benefits when due.

Cash balance plans are adopted for a variety of reasons. Some employers switch from a conventional defined benefit pension plan to a cash balance plan because they believe that the benefit formulas under conventional defined benefit pension plans are too complicated for employees to understand or appreciate. Cash balance plans offer a simple-to-understand alternative. Other employers who make the switch believe that conventional defined benefit pension plans inappropriately favor older workers over younger workers because of the use of final average compensation in the benefit formula. One way to substantially increase the benefits of younger workers is to adopt a cash balance plan that provides a deemed contribution that is an equal percentage of every employee's compensation.

Compared to a defined contribution plan, cash balance plans can appeal to employees who like the guaranteed interest rate that is not available under a defined contribution plan. On the other hand, the benefits of favorable investment experience flow to the employer under a cash balance plan (through reduced future plan contributions), an aspect that can be attractive for employers.

As noted above, cash balance plans are relatively new and several issues as to how they should be structured remain unsettled. Moreover, the IRS has repeatedly indicated that it plans in the near future to issue new guidance clarifying the rules with respect to cash balance plans. Although the new guidance may focus primarily on nondiscrimination issues—which may be of less concern to NEA members—other significant issues may also be addressed by the IRS.

Floor-offset plans

A floor-offset plan is a defined benefit pension plan with one distinctive characteristic. The benefits provided under the defined benefit pension plan are offset by the value of benefits provided under another plan of the same employer, typically a defined contribution plan. For example, a defined benefit pension plan might provide an employee with a benefit equal to 1 percent of final average compensation multiplied by the employee's years of service, offset by the life annuity starting at normal retirement age that could be purchased with the employee's account balance under a defined contribution plan.

A floor-offset plan can be used to address a variety of needs. For example, an employer might use a defined contribution plan as its primary source of retirement benefits. In order to ensure a certain minimum retirement benefit, the employer might add a floor-offset plan. The floor-offset plan would protect employees from unfavorable investment experience in the defined contribution plan. The floor-offset plan would also protect the interests of employees who join the work force at an older age; defined contribution plans, particularly those that are not age-weighted, generally do not provide an adequate retirement benefit for such employees.

Special Rules Applicable to Deferred Compensation Plans

The tax treatment described above for qualified deferred compensation plans is very favorable. For example, under general tax principles, individuals are taxable on amounts paid into a trust on their behalf by their employer if and when such amounts become substantially vested, even if they have not at that time received the deferred compensation in current cash compensation. Also under general tax principles, the income earned by such a trust is subject to income tax. The more favorable tax treatment of qualified plans is, however, conditioned on the plan's meeting the applicable standards for qualification.[8] These rules are summarized below.

With respect to nonqualified deferred compensation plans, a Section 457(a) plan is treated favorably as compared to a Section 457(f) plan, as discussed above. Such treatment is conditioned on the Section 457(a) plan's meeting certain requirements, which are also discussed below.

In addition, this section of the report describes certain special rules with respect to the tax treatment of distributions from deferred compensation plans.

Availability of Plan Assets for Distribution to Employees

Prohibitions on availability

In order to qualify for favorable tax treatment,

[8] *The IRS has stated, however, that pending further review, it will not challenge the tax-exempt status of trusts maintained in connection with the retirement plan of a state or local government.*

a deferred compensation plan must restrict an employee's ability to receive assets from the plan prior to the occurrence of certain events.

A plan may be more restrictive than is required by law. For example, even if the law would permit a certain type of plan to make distributions to an employee prior to termination of employment, the plan may by its terms prohibit such distributions.

Defined benefit pension plans

A defined benefit pension plan may not make a distribution to an employee of benefits funded by the employer until the employee has terminated employment, become disabled, attained normal retirement age under the plan, or died, or until the plan has terminated.

After-tax employee contributions and the income attributable to such contributions are, however, subject to different rules. If no employer-funded benefit is conditioned on an after-tax employee contribution, a defined benefit pension plan may allow such contribution and the income attributable to such contribution to be withdrawn by the employee at any time. If, however, an employer-funded benefit has been conditioned on the after-tax employee contribution, such contribution and the income thereon appear to be subject to the same restrictions applicable to employer-funded benefits, with very limited exceptions.

Defined contribution plans

Distributions from a money purchase pension plan are subject to the same restrictions applicable to a defined benefit pension plan.

The rules with respect to distributions from a profit-sharing plan are much more liberal than those applicable to defined benefit pension plans. A profit-sharing plan generally may distribute to an employee any employer contributions and the income attributable to such contributions if (1) the assets to be distributed have been in the trust for at least two years; (2) the employee has attained an age specified in the plan (which need not be normal retirement age); (3) an event has occurred with respect to the employee (such as layoff, hardship, illness, disability, retirement, death, or severance of employment); (4) the plan terminates; or (5) the employee has participated in the plan for at least five years.

A 401(k) plan, which is generally a type of profit-sharing plan, is, however, subject to restrictions on distributions of pretax employee contributions (and certain employer contributions) and the income thereon that are more restrictive than those applicable to other profit-sharing plans (but not as restrictive as those applicable to defined benefit pension plans).

After-tax employee contributions to profit-sharing plans are subject to the most liberal distribution rules. If no employer contribution is conditioned on an after-tax employee contribution, a profit-sharing plan may provide that the employee contribution and the income attributable thereto may be withdrawn by the employee at any time.

If an employer contribution has been conditioned on the employee contribution, the plan may allow employees to have this same freedom of withdrawal, except that the plan has to provide a mechanism for, in effect, limiting the exercise of these withdrawal rights. Such a limitation might require, for example, that the amount withdrawn have been in the plan for a certain minimum period (such as two years). If employees wish to exercise their withdrawal rights prior to the expiration of such period, an alternative limitation might be the suspension of the employee's right to make or receive contributions for six months following exercise of the withdrawal rights.

Section 403(b) plans

Under a Section 403(b) plan, amounts that are used to purchase annuity contracts generally may be distributed at any time. This rule, however, does not apply to elective pretax employee contributions and the income attributable to such contributions. Such pretax employee contributions may not be distributed until the employee attains age 59½, separates from service, dies, becomes disabled, or incurs a hardship. The same restrictions apply to the income earned on elective pretax employee contributions except that the hardship rule does not apply.

Under a "grandfather rule," the restrictions on distribution of elective pretax employee contributions (and the income thereon) do not apply to amounts that were in the plan as of the end of the last plan year beginning before 1989. (The restrictions do apply, however, to the earnings on the grandfathered amounts).

All amounts in a Section 403(b) plan that are held in a custodial account are subject to the same distribution restrictions applicable to elective pretax employee contributions used to purchase an annuity contract, except that the grandfather rule does not apply.

SEPs

Distributions from a SEP may be made at any time.

Section 457 plans

Under a Section 457(a) plan, distributions with respect to an employee may not be made until the employee separates from service or has an enforceable emergency (which is a narrower category than "hardship").

Ten percent early distribution penalty tax

Even if a deferred compensation plan may make a distribution under the rules described above without jeopardizing its favorable tax treatment, a 10 percent penalty tax will apply to the recipient of a taxable distribution unless the distribution is made for one of the following reasons:

(i) made on or after the date the employee attains 59½
(ii) made on or after the employee's death
(iii) attributable to the employee being disabled
(iv) made in the form of a life annuity, a joint and survivor annuity, or a similar form, provided that the payments begin after the employee separates from service
(v) made after the employee separates from service, provided that the employee does so during or after the calendar year in which he/she attained age 55
(vi) not in excess of the employee's deductible medical expenses for the year (or the amount that would be deductible if the employee itemized deductions)
(vii) made to a family member of the employee's (or former family member) under a state court domestic relations order

These rules apply to all deferred compensation plans except that (1) the exceptions described in clauses (v), (vi), and arguably (vii) do not apply to SEPs; (2) the requirement in clause (iv) that the employee have separated from service does not apply to SEPs; and (3) distributions under Section 457(a) plans are not subject to the 10 percent penalty tax in any case.

Plan loans

Employees may generally be permitted to borrow plan assets from a defined benefit pension plan, defined contribution plan, or Section 403(b) plan without jeopardizing the plan's favorable tax treatment. (As a practical matter, loans from the latter two types of plan are much more common than loans from defined benefit pension plans.) Such loans are not permitted with respect to SEPs. In the case of a Section 457(a) plan, any loan to an employee would technically be treated as a loan from the employer and thus would not be subject to any special rules.

A loan from a defined benefit pension plan, defined contribution plan, or Section 403(b) plan is generally treated as a loan, rather than as a distribution, and thus is not subject to income taxes or penalty taxes. However, some or all of a plan loan will be treated as a distribution for such purposes if the loan violates certain requirements. Very generally, those requirements are as follows.

Limitation on amount

The sum of all outstanding loans to an employee from all plans of an employer may not exceed the lesser of $50,000 or the greater of $10,000 or 50 percent of the value of the employee's vested benefits under the plans.

In addition, very generally, the $50,000 maximum is reduced by the amount of loan principal paid by the employee during the prior 12 months.

Repayment period

In general, a plan loan must be required to be repaid within five years and must, in fact, be repaid within five years. There is an exception from this rule for loans used to acquire the employee's principal residence. There is no official guidance as to what repayment period is permissible with respect to a principal residence loan.

Quarterly payments

Plan loans must be repaid in substantially equal payments that are made at least quarterly. Of course, the loan may also be repaid or accelerated prior to the end of the stated term.

Pledges

For purposes of the requirements listed above, employees who pledge or assign any portion of their plan benefits shall be treated as having received a plan loan of the amount pledged or assigned.

Effect on the plan

Even if a loan is treated as a distribution because it does not satisfy the rules described above, it is not necessarily treated as a distribution for purposes of the prohibitions on distributions. A loan generally will be treated as a distribution for those purposes only if it is not a bona fide loan, that is, there was no real intent that the loan would be repaid.

Minimum distribution rules

In general, a deferred compensation plan does not qualify for favorable tax treatment unless the plan requires that employees begin receiving distributions from the plan by no later than April 1 of the year immediately following the later of (1) the year the employee attains age 70½ or (2) the year the employee retires. The year the employee retires does not apply to a SEP. In addition, the commencement of distribution of amounts that were in a Section 403(b) plan as of December 31, 1986, may be delayed beyond the dates described above, but generally not beyond age 75.

Limits on Benefits and Contributions

In order to qualify for favorable tax treatment, a deferred compensation plan must limit the contributions or benefits that it provides to each employee.

The limits discussed below are in certain circumstances a function of an employee's compensation. For a discussion of an issue affecting the amount of compensation an employee is treated as receiving for these purposes, see "Pretax employee contributions," page 37.

Defined benefit pension plans

In general, under Section 415 of the Internal Revenue Code, employees may not be entitled to an annual benefit attributable to employer contributions under a defined benefit pension plan in excess of the lesser of $118,800 (indexed) or the employees' average compensation over the three-consecutive-year period in which their compensation was the highest (indexed in years after the employee separates from service).

Under proposed legislation, the "average compensation" rule described above would be inapplicable to any defined benefit pension plan maintained by a state or local government (or by the federal government).

Both the $118,800 (indexed) figure and the average compensation limit may be reduced with respect to an employee who is (or has been) a participant in a defined contribution plan or a SEP maintained by the same employer. This reduction applies under Section 415(e) and can in certain circumstances have a very significant effect on the amount of annual benefits permitted with respect to a participant. If a participant in a defined benefit pension plan also participates in a Section 403(b) plan maintained by the same employer, rather than a defined contribution plan or SEP, the reduction under Section 415(e) only applies in limited, avoidable circumstances.[9] Accordingly, for an employer with a defined benefit pension plan that is considering adopting a supplemental qualified plan, Section 403(b) plans have this advantage.

Employee contributions

The benefit attributable to after-tax employee contributions to a defined benefit pension plan is not subject to the limit described above. Instead, for purposes of the Section 415 limits, employee contributions to a defined benefit pension plan are generally treated as contributions to a defined contribution plan.

It appears, though it is far from clear, that the

[9] *In circumstances in which the Section 415(e) reduction would otherwise apply to the annual benefit limit described above, an employer may choose to have the reduction apply instead to the defined contribution limit (which applies to Section 403(b) plans and SEPs, as well as to defined contribution plans) discussed below. Because of the manner in which Section 415(e) applies, however, it is generally advisable to have the reduction apply to the annual benefit limit described above.*

benefit attributable to pick-up contributions to a defined benefit pension plan is subject to the limit described above.

Ancillary benefits

If employees are entitled to certain types of ancillary benefits, such as payments after their death other than as a life annuity to their spouse, the ancillary benefits must be converted into a life annuity of equivalent value (for testing purposes only), added to the employee's regular benefit, and the total then tested against the limit described above. An example of an ancillary benefit that need not be valued and tested is a preretirement disability benefit.

Under proposed legislation, all disability and death benefits provided under a governmental defined benefit pension plan would be disregarded in applying the Section 415 limit and thus need not be valued and added to an employee's regular benefit.

Early or late retirement

If an employee's benefits under the plan begin before age 62, the $118,800 (indexed) figure must be actuarially reduced with respect to that employee to reflect the fact that benefits are commencing before age 62. However, if the benefit begins at or after age 55, the actuarial reduction shall not reduce $118,800 (indexed) to an amount lower than $75,000 (not indexed). If the benefit begins before age 55, the limit is the greater of (1) the actuarial equivalent of a $118,800 (indexed) benefit commencing at age 62, or (2) the actuarial equivalent of a $75,000 benefit commencing at age 55.

Since the $75,000 figure is not indexed, these actuarial reductions will become increasingly important in the future. The reductions could become particularly important if NEA members continue their preference for early retirement. The NEA 1992 Benefits Survey found that 11.9 percent of the respondents plan to retire by age 54 and 43.8 percent by age 59.

If an employee's benefit begins after age 65, the $118,800 (indexed) figure is actuarially increased to reflect the commencement of benefits after age 65.

$10,000 benefit permitted

A special rule allows a defined benefit pension plan to provide an annual benefit of $10,000 or less to an employee, even if that benefit would otherwise exceed the limit described above. This special rule only applies, however, if the employee has never been covered under a defined contribution plan or SEP (or in certain circumstances a Section 403(b) plan) maintained by the same employer.

Adjustment of limit based on years of service or participation

The $118,800 (indexed) limit is reduced proportionately for an employee who has less than ten years of participation in the plan. For example, if employees have only been participants for two years, their benefit could not exceed 20 percent of $118,800 (indexed), or $23,760 (indexed).

The average compensation limit and the special $10,000 amount are reduced in a similar fashion but based on years of service with the employer rather than years of participation in the plan.

Collective bargaining exemption

There is a narrow exemption from the average compensation limit for collectively bargained plans that meet a series of requirements, including, for example: (1) employees must be eligible to participate in the plan after not more than 60 days of service; (2) employees are 100 percent vested in their benefits after no more than four years of service; and (3) an employee's benefits are not determined by reference to the employee's compensation. Even if a plan meets the requirements, the exemption generally applies only to employees whose compensation is less than the average compensation of employees covered under the plan.

In general, the defined benefit pension plans in which NEA members participate are not collectively bargained, so that this exemption will generally be inapplicable.

Plan aggregation and disaggregation

For purposes of the limit described above, all defined benefit pension plans maintained at any time by an employer are treated as a single plan, that is, are "aggregated." Thus, if the benefits earned by an employee under two plans maintained by the same employer exceed the applicable limit in total, the limit is considered exceeded.

In addition, for purposes of the limit described above, related employers are treated as a single employer. (There is little guidance with respect to the circumstances in which public employers are considered to be related.)

If a single plan is maintained by two or more *unrelated* employers, the benefit earned under the plan by an NEA member is, for purposes of applying the limit described above, generally divided into separate benefits based on the benefits earned from each employer.

Special election

Congress has provided a special election to state and local government employers. If an employer makes this election, the limit described above is deemed satisfied with respect to an employee of such employer if the employee's benefit under the employer's plan does not exceed the amount that would be payable under the plan without regard to any plan amendments adopted after October 14, 1987. However, this favorable treatment only applies to employees who first became participants in the plan before January 1, 1990.

There is a significant condition attached to this election. If an employer makes this election, employees ineligible for the favorable treatment generally become subject to the version of the limit that applies to taxable employers. Under that version, the $118,800 (indexed) figure is actuarially reduced (or increased) if benefits begin before (or after) an employee's Social Security retirement age (which is between 65 and 67, depending on the employee's current age). In addition, the $75,000 rule described above does not apply. In comparison with the rules described above, this version of the dollar limit is much lower for employees who retire early and begin receiving their benefit.

The election must have been made by the end of the first plan year beginning after 1989.

Additional proposed legislation

Under proposed legislation, a governmental plan could provide benefits in excess of the Section 415 limits, provided that under the excess arrangement, no election is provided to an employee (directly or indirectly) to defer compensation. Very generally, the proposal would allow such additional benefits to be taxable to employees only upon their receipt of such benefits and would allow income earned by the benefits prior to distribution to be nontaxable to the employer (or to a separate trust holding the benefits). In all other ways, the excess portion of the plan would not be treated as a qualified plan.

The proposed legislation would also deem all governmental plans to be in compliance with Section 415 for all taxable years beginning before the date the legislation is enacted.

Because of the favorable legislative proposals described in this and other sections, the "special election" described above may no longer be advantageous. Accordingly, the proposed legislation also provides employers that have made the election with the option to revoke it.

Defined contribution plans

In general, under Section 415 of the Internal Revenue Code, the sum of the employer and employee contributions made on behalf of an employee to defined contribution plans in a year may not exceed the lesser of $30,000 (indexed on a delayed basis) or 25 percent of the employee's compensation. For this purpose, any amount that is forfeited by one employee in a defined contribution plan and is allocated to a second employee is treated as a contribution on behalf of the second employee.

"Rollover contributions" and "transfers," both of which are discussed below, are not treated as contributions for purposes of the limit described above.

As in the case of defined benefit pension plans, all defined contribution plans maintained by an employer are treated as a single defined contribution plan for purposes of the applicable limit. The rules with respect to related employers and with respect to a defined benefit pension plan maintained by two or more unrelated employers also apply to defined contribution plans.

Section 403(b) plans

Contributions made on behalf of an employee to a Section 403(b) plan are generally subject to two limits. First, such contributions are subject to the limit applicable to defined contribution plans under Section 415. However, unless an employee makes one of the elections referred to below, Section 403(b) plans are not aggregated with defined contribution plans for purposes of this limit.

Second, employer contributions and pretax employee contributions on behalf of an employee in a year may not exceed the "exclusion allowance" established under Section 403(b) itself. The exclusion allowance is generally the excess of 20 percent of the employee's taxable compensation for the year, multiplied by years of service with the employer, over the total of the nontaxable employer contributions and pretax employee contributions made by or with respect to the same employer to Section 403(b) plans, defined benefit pension plans, defined contribution plans, Section 457(a) plans, or certain 457(f) plans on behalf of the employee for all prior years.

There are special rules that under certain circumstances provide more liberal limits than those described above. Each employee may elect which, if any, of the special rules to use.

SEPs

For purposes of the Section 415 limits described above, a SEP is treated as a defined contribution plan. In addition, under Section 402(h) of the Internal Revenue Code, contributions to a SEP on behalf of an employee may not exceed the lesser of 15 percent of the employee's taxable compensation or $30,000 (indexed on a delayed basis) reduced by a certain amount in the case of SEPs that provide larger contributions for "highly compensated employees" than for "nonhighly compensated employees" (as a percentage of compensation). See "Nondiscrimination Rules" below for a definition of "highly compensated employee."

Section 457 plans

In general, under Section 457 itself, the limit on the amount that may be deferred on behalf of an employee in a year under a Section 457(a) plan is the lesser of $7,500 or one third of the employee's taxable compensation. There is also a special rule that provides a higher limit (up to $15,000) during an employee's last three years before normal retirement age. In addition, the $7,500 limit (or higher limit) is, in effect, reduced by (1) amounts deferred under other Section 457(a) plans on behalf of the same employee; (2) amounts contributed on behalf of the employee under a Section 403(b) plan; and (3) pretax employee contributions made on behalf of the employee under a 401(k) plan.

Under proposed legislation, the $7,500 figure referred to above would be indexed.

Special limit on elective pretax employee contributions

Elective pretax employee contributions are subject to the general limits described above and, in addition, they are subject to a special separate limit under Section 402(g) of the Internal Revenue Code. Generally, under this special limit an employee may not make more than $9,240 (indexed) of elective pretax employee contributions during a calendar year to all deferred compensation plans (other than Section 457(a) plans). However, with respect to elective pretax employee contributions to Section 403(b) plans, the limit is the higher of $9,240 (indexed) or $9,500 (not indexed). Accordingly, in the near future, when the $9,240 is indexed to exceed $9,500, there will be no special Section 403(b) limit.

For employees who have at least 15 years of service, the limit on elective pretax employee contributions to Section 403(b) plans is raised pursuant to a formula, with a maximum increase of $3,000.

Pick-up contributions are not subject to this special limit.

Penalty tax on excess distributions and excess accumulations

There is a 15 percent penalty tax that applies, in addition to the generally applicable income tax, to individuals who receive "excess distributions." For this purpose, very generally, individuals have an excess distribution if in a calendar year they receive from all deferred compensation plans (other than Section 457(a) plans) and IRAs taxable distributions in excess of the greater of $148,500 (indexed) or $150,000 (not indexed). In addition, a comparable 15 percent tax applies to individuals who die with very large accumulations of assets in deferred compensation plans (other than Section 457(a) plans) and IRAs.

Special Tax Treatment of Distributions

Distribution rolled over to another plan or IRA[10]

Defined benefit pension plans

If a distribution from a defined benefit pension plan is "rolled over" (that is, contributed under certain circumstances described below) to another defined benefit pension plan, a defined contribution plan, or an IRA, the amount rolled over is not taxable at that time to the employee.

Very generally, all distributions may be rolled over with the following exceptions: (1) periodic payments made over the life of the employee (or over the lives of the employees and their beneficiaries); (2) periodic installment payments made over a period of at least ten years; (3) the minimum amount required to be distributed under the rules described above; (4) any amount of a distribution that is not taxable to the recipient (for example, because it is a return of after-tax employee contributions); and (5) certain miscellaneous, less common types of distributions (such as a distribution to cure a violation of Section 415). Distributions that may be rolled over are referred to as "eligible rollover distributions."

There are generally two types of rollovers: rollovers made by the employee-recipient and direct rollovers. In the former case, the employee receives an eligible rollover distribution from a defined benefit pension plan. In order to roll over the eligible rollover distribution, the employee must, within 60 days of the distribution, contribute the distribution to another defined benefit pension plan, a defined contribution plan, or an IRA. The employee may roll over all or only a portion of the eligible rollover distribution.

A defined benefit plan that makes an eligible rollover distribution available to an employee generally must also make available to the employee the option of a "direct rollover." A direct rollover is a direct transfer of some or all of the eligible rollover distribution to a defined contribution plan or an IRA designated by the employee. (A direct rollover may not be made to a defined benefit pension plan.) As in the case of a rollover made by an employee, the amount of the direct rollover is not taxable to the employee at the time it is made.

The law also includes an incentive for employees to elect a direct rollover. Generally, any portion of an eligible rollover distribution that is received by the employee rather than directly rolled over is subject to mandatory 20 percent withholding.

The administrator of a defined benefit pension plan must provide a written explanation of the rollover and withholding rules (and, if applicable, the rules regarding the special tax rates described below) to an employee within a certain period before an eligible rollover distribution becomes payable.

All of the rules described above regarding rollovers apply not only to employees but also to distributions to a deceased employee's surviving spouse and distributions to a spouse or former spouse pursuant to a domestic relations order. However, rollovers with respect to a surviving spouse may only be made to an IRA, not to a defined contribution plan.

Defined contribution plans

Same as defined benefit pension plans described above.

[10] *For a discussion of another means of moving assets from one deferred compensation plan to another without taxation, see "Asset Portability," below.*

Section 403(b) plans

The same rules applicable to defined benefit pension plans apply to Section 403(b) plans except that rollovers from Section 403(b) plans may only be made to other Section 403(b) plans or to IRAs.

SEPs

SEPs are generally subject to the same rollover rules applicable to IRAs. Thus, any SEP distribution is eligible to be rolled over but only to an IRA. In addition, there is no mandatory 20 percent withholding and no requirement that a direct rollover option be provided. Finally, only one IRA distribution may be rolled over during a 12-month period though this limitation does not apply to direct transfers between IRAs.

Section 457 plans

Distributions from Section 457(a) plans may not be rolled over to any other type of plan. However, amounts to which an employee is entitled may be transferred directly from one Section 457(a) plan to another Section 457(a) plan.

Distribution of after-tax contributions

As discussed above, in general, a distribution from a deferred compensation plan is taxable to the recipient except to the extent that the distribution is considered to be a return of the employee's after-tax contributions. Thus, in the case of plans that permit after-tax employee contributions, it is necessary to determine the amount of a distribution that is considered to consist of after-tax employee distributions.

Prior to the Tax Reform Act of 1986, the law permitted, under certain circumstances, the first distributions from a deferred compensation plan to be considered to be after-tax employee contributions. Thus, employees could generally receive on a nontaxable basis all of their after-tax employee contributions prior to receiving any taxable amounts. (One of the rules that permitted such tax treatment was often referred to as the "3-year basis recovery rule.")

However, the Tax Reform Act of 1986 generally provided that each distribution will be treated as consisting partially of a nontaxable return of after-tax employee contributions and partially of taxable amounts. (There are "grandfather" rules preserving the old system for certain distributions.) Very generally, the proportions of nontaxable and taxable amounts will be based on the total amount of each to which the employee is entitled under the plan.

Special tax rates applicable to lump sum distributions

In general, a lump sum distribution from a defined benefit pension plan or defined contribution plan is eligible for taxation at lower rates if no part of the distribution is rolled over. A lump sum distribution is generally a single distribution of all amounts that an employee is entitled to under the plan (and under certain other plans maintained by the employer). In addition, to be a lump sum distribution, a distribution must be made (1) on account of the employee's death, (2) after the employee attains age 59½, or (3) on account of the employee's separation from service.

In order to qualify for taxation at lower rates, the lump sum distribution must meet the following requirements. First, the distribution generally must be received after the employee has attained age 59½. Second, the employee generally may not have used the special lower tax rates with respect to any prior lump sum distribution. Third, the employee must have been a participant in the distributing plan for at least five years prior to the year of distribution.

In general, the special lower tax rates are achieved through a rule called "5-year averaging."

This is one of the areas where the treatment of money purchase pension plans differs from that of profit-sharing plans. In general, in determining whether a distribution constitutes a lump sum distribution for purposes of the special tax rates, a money purchase pension plan is aggregated with a defined benefit pension plan. Accordingly, if an employee is entitled to benefits under both a money purchase pension plan and a defined benefit pension plan and such employee receives a total distribution from the former but not from the latter, the distribution does not constitute a lump sum distribution (because it was not a total distribution from the combined plans). If, however, in this example, the former plan were a profit-sharing plan rather than a money purchase pension plan, the distribution described in the previous sentence would constitute a lump sum distribution.

The special lower tax rates do not apply to Section 403(b) plans, SEPs, or Section 457(a) plans.

Proposed legislation would eliminate the special lower tax rates, subject to an exception for individuals who were age 50 prior to January 1, 1986.

Nondiscrimination Rules

Nondiscrimination rules generally require that deferred compensation plans (other than Section 457(a) plans) not favor an employer's highly compensated employees over the employer's nonhighly compensated employees. See Sections 401(a)(4), 401(k), 401(m), 403(b)(12), 410(b), and 410(c) of the Internal Revenue Code. Another aspect of the nondiscrimination rules, which is contained in Section 401(a)(26) of the Internal Revenue Code, generally requires that all such plans cover at least the lesser of 50 employees or 40 percent of the employer's employees. (Although this aspect of the rules does not apply to SEPs, typically more restrictive rules apply to SEPs under Section 408(k) of the Internal Revenue Code.)

The IRS has, with certain exceptions, suspended the application of all nondiscrimination rules to public plans until 1996 at the earliest. The exceptions are SEPs and the part of a Section 403(b) plan that accepts elective pretax employee contributions.

During the period prior to 1996, the IRS may well establish special rules for public plans that take into account their unique circumstances. When the nondiscrimination rules do become applicable to public plans, it is also possible that they will not immediately apply to public plans that are maintained pursuant to a collective bargaining agreement ratified prior to the date that the IRS establishes such special rules. It is also possible that the period during which the nondiscrimination rules do not apply to public plans will be extended beyond 1995.

Even if the nondiscrimination rules were to be made applicable without any additional special rules for public plans, in certain cases described below the nondiscrimination rules would not have much effect on NEA members.

Plans without highly compensated employees

First, if NEA members are covered by their own plan and none of those members are highly compensated employees, then with certain limited exceptions, the plan automatically satisfies the nondiscrimination rules. Those exceptions are generally SEPs and the part of a Section 403(b) plan that accepts elective pretax employee contributions.

In this regard, the following provides a very general summary of the definition of a highly compensated employee as it will apply to most public educational institutions.[11] A highly compensated employee includes any employee who in the preceding year received compensation in excess of $66,000 (indexed) or was an officer of the employer and received compensation in excess of $59,400 (indexed).[12] Employees are also highly compensated if they meet one of these requirements the current year and are in the top 100 employees of the employer by compensation. Finally, if, in a year, no employee of the employer meets one of the above requirements, the highest paid employee is considered highly compensated.[13]

[11] *Rules relating to employees who receive compensation in excess of $75,000 (indexed) or who are in the top 20 percent of the employer's employees by compensation are not described because they rarely have a practical effect on public employers. A rule relating to employees who own more than 5 percent of the employer is also omitted. Technically, the definition of "highly compensated employee" described in the text and in this footnote, which is contained in section 414(q) of the Internal Revenue Code, does not apply for purposes of one of the nondiscrimination tests applicable to defined benefit pension plans and defined contribution plans. The determination of highly compensated employees for purposes of that test is based on all the facts and circumstances. However, it may well be reasonable to use the more precise section 414(q) definition under the facts and circumstances.*

[12] *The figures set forth in the text are for 1994. The 1993 figures, which are also relevant for determining highly compensated employee status in 1994, are $64,245 and $57,821, respectively. There are limits on the number of employees who must be treated as officers.*

[13] *The definition of "highly compensated employee" set forth in the text would be slightly altered by pension simplification bills currently ,pending in Congress.*

Special rules for collectively bargained plans

The second situation in which the nondiscrimination rules would not have much effect on NEA members is if the plan in which the members participate is maintained pursuant to a collective bargaining agreement. In general, based in part on proposed new IRS regulations, there is a strong argument that if a collectively bargained plan for NEA members benefits at least the lesser of 50 employees or 40 percent of the NEA members covered by the collective bargaining agreement, the plan automatically satisfies the nondiscrimination rules. (In fact, if a collectively bargained plan covers NEA members employed by more than one employer, the "50 employees/40 percent" rule does not apply to coverage of the NEA members.)

The most significant exceptions to this general rule are SEPs, Section 401(k) plans with respect to the availability and amount of pretax employee contributions, and the part of a Section 403(b) plan that accepts elective pretax employee contributions. In addition, this general rule does not apply to the extent that employees of the plan or of NEA itself are covered under the plan.

Generally, defined benefit pension plans in which NEA members participate are not collectively bargained, but rather are determined by state law. On the other hand, other types of deferred compensation plans maintained for NEA members are generally the product of collective bargaining. Because these other types of plans are generally collectively bargained, the potential nondiscrimination problems for NEA members with respect to such plans are generally limited to SEPs and elective pretax employee contributions to Section 403(b) plans. Moreover, these potential problems can be avoided by treating all employees in the same manner under the plan.

With respect to such collectively bargained plans, eligibility requirements (such as age, service, or job classification requirements) for participation in a plan for NEA members may generally be determined without regard to the nondiscrimination rules. The same is also true of the eligibility requirements for specific levels of benefits under the plan.

Rules for noncollectively bargained plans

As noted above, the defined benefit pension plans in which NEA members participate are generally not collectively bargained and thus, if they cover any highly compensated employee, may become subject to the full range of nondiscrimination rules.

It is difficult to generalize with respect to the effect of the nondiscrimination rules on such defined benefit pension plans. The nondiscrimination rules, as they currently exist, are long, complex, and not necessarily intuitive in all cases. For example, if a plan treats all employees in exactly the same manner, one might think that the nondiscrimination rules would not raise an issue. However, that is not necessarily true. Such a plan might fail to satisfy the nondiscrimination rules because of different options elected by employees.

Because (1) it is difficult to generalize about the nondiscrimination rules, (2) the rules may be further delayed with respect to governmental plans, and (3) extensive special rules may be issued with respect to governmental plans, this report does not discuss the nondiscrimination rules any further. It is enough to say that if these rules apply to governmental plans without significant modifications, achieving and demonstrating compliance may be quite burdensome and take a significant amount of time. Accordingly, this is an area that warrants monitoring.

Compensation limits

Only $150,000 (indexed) of an employee's compensation can be taken into account under any deferred compensation plan other than a Section 457(a) plan and possibly the part of a Section 403(b) plan that accepts elective pretax employee contributions. However, this rule does not apply to public plans until 1996 at the earliest; there is also a delay for collectively bargained plans that could in certain circumstances render the rule inapplicable until 1997. Even when the rule begins to apply, certain employees will be permanently exempted from its application. (The application to SEPs of the delayed effective dates described above, other than the collectively bargained plan provision, is unclear.)

Vesting Rules

Defined benefit pension plans and defined contribution plans

The vesting rules applicable to defined benefit pension plans and defined contribution plans maintained by private employers do not apply to such plans as maintained by state or local governments. There are, however, certain vesting rules that do apply to public plans. First, if a plan is terminated or there has been a complete discontinuance of contributions under the plan, employees' benefits under the plan must be 100 percent vested to the extent there are sufficient assets in the plan. For purposes of this rule, a "termination" includes both a partial termination and a complete termination of a plan. A partial termination may occur, for example, when a substantial group of employees who were covered by the plan are excluded by reason of a plan amendment or by reason of being discharged by the employer. A partial termination may also occur if the plan's benefits are reduced or the plan's requirements for eligibility or vesting are made more stringent.

Under a second vesting rule, the application of the plan's vesting schedule must not result in discrimination in favor of higher paid employees. Such discrimination may occur, for example, if the rate of turnover among lower paid employees is significantly higher than the rate of turnover among higher paid employees. If an employer adopts a rapid vesting schedule,[14] however, the employer generally avoids the risk of such a finding of discrimination (unless the employer engages in abusive practices such as firing employees immediately before they become vested).

It appears, though not clearly, that the application of this vesting nondiscrimination rule to public plans is suspended until at least 1996 under the generally applicable suspension of nondiscrimination rules described above.

It also appears, though not clearly, that a plan maintained by a state or local government must provide that an employee's benefit will be 100 percent vested when the employee attains the plan's normal retirement age and satisfies other requirements applicable under the plan such as with respect to service for the employer or employment with a subsequent employer. In the case of a profit-sharing plan, the normal requirement age provision does not apply.

If an employee does not become 100 percent vested in the benefit and thus forfeits the unvested portion, the forfeited amount generally must be treated, in effect, as an employer contribution to the plan, thus decreasing the amount the employer actually has to contribute. In the case of a defined contribution plan, however, an employee's forfeiture may alternatively be used to increase the benefits of other employees.

Section 403(b) plans

Although Section 403(b) plans are typically 100 percent vested at all times, they are not required to be. Section 403(b) plans appear to be subject only to the vesting nondiscrimination rule (which, as noted, may not apply until at least 1996).

SEPs

Contributions to SEPs must be 100 percent vested at all times.

Section 457(a) plans

There are no vesting rules applicable to Section 457(a) plans.

Portability

In general, the concept of portability relates to employees' ability to preserve their deferred compensation benefits when they move to a new employer. Discussion of this concept is divided below into two general topics: asset portability and service portability.

Asset portability

The term "asset portability" is used in this report to refer to an employee's ability to move

[14] *The following is an example of such a rapid schedule:*

Completed years of employment	*Vested percentage*
4	40%
5	45%
6	50%
7	60%
8	70%
9	80%
10	90%
11 or more	100%

retirement benefits from a former employer's plan to a new employer's plan or to an IRA.

There are two ways to move retirement benefits from one plan to another plan or to an IRA. One way is by a rollover. The rollover rules are described above. It should be noted, however, that a rollover to a plan (as opposed to an IRA) is only possible if the recipient plan accepts rollovers (which not all plans do).

The second way of moving retirement benefits is by a direct transfer from one plan to another plan or IRA. (A transfer pursuant to an employee's election of a direct rollover is not a direct transfer for this purpose.) Transfers are permitted from defined contribution plans to other defined contribution plans or to defined benefit pension plans. Transfers from defined benefit plans to other defined benefit plans or to defined contribution plans are permitted, but, in certain cases, only on the condition that the transferor plan has been terminated, thus triggering 100 percent vesting. Transfers between Section 403(b) plans are permitted, as are transfers between Section 457(a) plans. Finally, SEPs are composed of IRAs, and transfers between IRAs are permitted.[15]

The transfers described above generally may consist of all or a portion of an employee's benefits under the transferor plan. However, in certain cases, restrictions on the employee's benefits that apply under the transferor plan (such as withdrawal restrictions described above) must apply to the transferred benefits in the transferee plan. In addition, a transfer is only possible if it is permitted by both the transferor and transferee plan.

Service portability

The concept of service portability is generally relevant only to defined benefit pension plans. An employee's benefits under a defined benefit pension plan are generally determined based on the employee's number of years of service and compensation history with the employer. However, an employer's defined benefit pension plan is generally not prohibited from giving one or more employees credit for years of service for and/or compensation from another employer or class of employers. (Some public plans may currently provide credit for other governmental service within the same state; probably no public plan credits service for a public employer in another state.) Such credit would remove a significant impediment to changing jobs. (If, however, an employer provides such credit to an employee under its defined benefit pension plan, the employer may also wish to include a provision in the plan under which the employee's benefits are reduced by the benefits earned by the employee from the employer with respect to which credit is being given.)

Although as noted there is no flat prohibition against such credit, the amount of credit a particular employee may receive may be limited. As noted above, the $118,800 (indexed) limit generally is phased in over ten years of participation in the current employer's defined benefit pension plan; thus, employees with one year of participation in such plan are limited to $11,880 (indexed), regardless of their years of participation in another employer's plan. Also as noted above, the average compensation limit is subject to a similar phase-in except that it is based on years of service with the current employer. Moreover, the average compensation limit is based on compensation from the current employer, without regard to compensation from another employer.

The limit problems described in the prior

The transfers described above are the most common. Under certain circumstances, transfers not described above may also be permitted.

paragraph do not apply if the employers are related and thus are treated as a single employer for the purposes of the limit. The limit problems also might not apply if an employee's benefit under a prior employer's plan is transferred to the new employer's plan; that might permit the new employer's plan to take into account service and compensation with the prior employer for purposes of the limit.

ERISA

Deferred compensation plans maintained by state and local governments are exempt from the non-tax rules of the Employee Retirement Income Security Act of 1974 (ERISA). Thus, such plans are exempt from the federal fiduciary rules that govern matters such as how trust assets are invested. Of course, any fiduciary standards under state law would apply. In addition, the Internal Revenue Code requires, as a condition of the favorable tax treatment described above, that (1) defined benefit pension plans and defined contribution plans be maintained for the "exclusive benefit" of the employer's employees (and their beneficiaries) and (2) transactions between the employer and such plans be fair to the plan. These rules would be violated if, for example, the trust assets are used not for the benefit of the employees but rather for the employer's own purposes. Thus, the investment of trust assets, as well as other aspects of plan operation, are subject to tax rules protecting the interests of the employees.

Due to their exemption from ERISA, governmental defined benefit pension plans are not insured by the Pension Benefit Guaranty Corporation (PBGC) and, accordingly, need not pay premiums to the PBGC.

Miscellaneous

Advance determinations from the IRS

The IRS has established a special procedure that employers can use to apply for an IRS determination that a defined benefit pension plan or defined contribution plan satisfies the requirements under the Internal Revenue Code for the favorable tax treatment, that is, a determination that the plan is qualified. Technically, a favorable determination letter does not ensure that the IRS will not later claim that the plan is retroactively disqualified. However, generally, the IRS will only do so if there has been a change in the law or in the relevant facts, the employer did not disclose all the relevant facts in its application, or the plan was not operated in accordance with the law and the documents submitted by the employer.

The special procedure referred to above does not apply to Section 403(b) plans, SEPs, or Section 457(a) plans. However, employers may generally obtain a similar letter from the IRS with respect to these plans by submitting an application for a "private letter ruling."

Neither determination letters nor private letter rulings are required in order for a plan to be entitled to favorable tax treatment. However, the great majority of private sector employers apply for such a letter or ruling in order to decrease the chances that the IRS will subsequently assert that the plan did not meet the applicable requirements under the Internal Revenue Code for favorable tax treatment. It is less common for governmental employers to seek a letter or ruling.

Programs to address rule violations

If a deferred compensation plan that is intended to satisfy the requirements for qualified status is found to have violated those requirements, the effect can be significantly adverse. For example, employees would become taxable on amounts paid into a trust on their behalf if and when such amounts become substantially vested, even if they have not at that time received the deferred compensation in cash. The draconian nature of the effects of "disqualification" has led the IRS in recent years to develop alternative means of addressing violations of the qualification rules.

One of those alternative means is the Voluntary Compliance Resolution (VCR) program. The VCR program only applies to defined benefit pension plans and defined contribution plans that have received an IRS determination letter that reflects a review of the plan under laws enacted through 1984. Moreover, it only applies to operational violations of the qualification rules; a violation contained in a plan document is not eligible for the VCR program. Also ineligible for the VCR program are egregious violations and "exclusive benefit violations."

Under the VCR program, an employer (1) admits in writing to the IRS that its plan has operationally violated the qualification rules, (2) corrects the violation retroactively and prospectively in a manner that satisfies the National Office of the IRS, and (3) pays a compliance fee to the IRS that varies from $350 to $10,000 based on a number of factors. The admission described in (1) must be made before the employer has been notified of an IRS examination of the plan. If the employer and the IRS cannot agree on a method of correction, the IRS may pursue disqualification of the plan. In the case of certain violations, the IRS has published methods of correction that are acceptable, though not the only acceptable methods.

The VCR program was scheduled to expire January 1, 1995, but there have been informal reports that it may be made permanent.

Another alternative sanction system is the Closing Agreements Program (CAP), which, like the VCR program, is limited to defined benefit pension plans and defined contribution plans. However, all qualification violations, including documentary violations, are eligible for the CAP except violations involving significant discrimination in favor of highly compensated employees; exclusive benefit violations; and repeated, deliberate, or flagrant violations. The CAP can apply without regard to whether (1) a plan is already under IRS examination, (2) the IRS discovers the violation (as opposed to the employer identifying the issue for the IRS), or (3) the plan has a determination letter. Under the CAP, the employer must correct the violation retroactively and prospectively, as in the case of the VCR program. In addition, the employer is subject to a monetary penalty that is negotiable with the IRS but is generally based on an agreed-upon percentage of the total taxes that would be due if the plan were disqualified. The CAP is administered by the IRS key district offices, which are to consult with the IRS National Office with respect to large cases.

There is also a special voluntary CAP for employers that do not qualify for the VCR program (for example, they do not have a determination letter), but who identify the violation for the IRS before being notified of an IRS examination of the plan. All CAP rules apply except (1) repeated, deliberate, or flagrant violations are eligible and (2) the monetary sanction is limited, though it may still be a large number.

Finally, there is the Administrative Policy Regarding Sanctions (APRS), which, like the other programs, only applies to defined benefit pension plans and defined contribution plans. In general, the APRS is limited to operational violations (other than exclusive benefit violations) that meet certain specific *de minimis* standards and that are corrected as soon as they are discovered. Where the APRS applies, there is no monetary sanction, compliance fee, or other type of payment to the government.

There have been informal reports that the IRS may develop at least one set of alternative sanctions for Section 403(b) plans. A June article in the *Daily Tax Report* (published by the Bureau of National Affairs, Inc.) indicates that, according to a senior IRS official, the alternative system will not be an expansion of the VCR program or the CAP, but rather will be tailored to the unique characteristics of Section 403(b) plans.

Excess assets

A trust maintained in connection with a defined benefit pension plan may have assets in excess of the amount necessary to pay out all benefits to which employees are entitled. (This is generally not true of the other types of deferred compensation plans because in those plans all contributions and income generated by the contributions are generally allocated to the accounts of the employees.) An employer may include a clause in a plan entitling the employer to receive the excess assets as a "reversion" if the plan is terminated at a time when there are excess assets. However, employees may bargain for a plan provision entitling them to part or all of the excess assets.

Although a tax of up to 50 percent generally applies to reversions, it is generally not applicable in the case of a state or local government.

As noted above, an employer can have access to excess assets in a defined benefit pension plan when that plan is terminated. Prior to termination of the plan, however, an employer is generally prohibited by Section 401(a)(2) of the Internal Revenue Code from withdrawing any of the excess assets or generally from using any of the plan's assets for any purpose other than for the exclusive benefit of employees covered by the plan or their beneficiaries. (This "exclusive benefit rule," which is referred to in several places throughout this report, also applies to defined contribution plans.)

The exclusive benefit rule, which was reportedly a problem for the Rhode Island pension plan (as discussed in the Introduction), can be helpful to NEA members in that it can prevent a state or local government from using plan assets for its own purposes. NEA members should be aware, however, that there is a technique that employers can use to gain access to excess assets, assuming no contrary provision in the plan, collective bargaining agreement, or applicable state or local law. Under this technique, an employer can terminate a defined benefit pension plan, recover the excess assets, and instantaneously reestablish the same plan. This may seem to be an elevation of form over substance, but it has been expressly permitted by the IRS.

There are, however, conditions that the IRS places on use of the above technique. Essentially, those conditions are that the termination be treated as a real one. Thus, for example, all plan benefits must be fully vested. Although the conditions are generally beneficial to plan participants, NEA members may still have an interest in preventing state or local governments from depleting a plan's excess assets. A plan without excess assets may easily become underfunded due to unfavorable investment experience or even the aging of the covered employees. Underfunding, in turn, can jeopardize future benefit improvements and possibly accrued benefit payments themselves. Accordingly, it may be in the interest of NEA members to prohibit state or local governments' access to excess assets, through, for example, specific plan provisions and/or state legislation.

Actuarial assumptions

Generally, an employee's benefit under a defined benefit pension plan is stated in terms of an amount, determined under the plan's formula, payable in a certain annuity form. However, as discussed above, the employees may receive their benefit in a different form, possibly in the form of a lump sum. This requires the plan to establish the value of the employee's benefit in the basic form and to determine the amount that must be paid in the different form so that the employee receives an equivalent value. This "equivalent value determination" is based on certain actuarial assumptions, such as interest rates. These assumptions, which generally must be specified in a defined benefit pension plan, can have a very significant effect on whether the amount paid in the different form actually has an equivalent value.

Pretax employee contributions

Most nonelective contributions or benefits provided by an employer are based on an employee's compensation. It is important to consider the effect of pretax employee contributions on the definition of compensation that is used for this purpose. For example, an elective contribution by an employee under a Section 457(a) plan might result in a smaller amount of compensation taken into account under an employer's defined benefit pension plan, with the result that the employee's benefit under the defined benefit pension plan is smaller.

Employees may be able to negotiate for a definition of compensation that takes into account pretax employee contributions (unless the definition is fixed by state statute, for example). However, for purposes of the limits on contributions or benefits discussed above, compensation does not include pretax employee contributions, nor does it include any employer contributions (such as Section 414(h) pick-up contributions). Thus, even if there is a favorable definition of compensation under a plan, the favorable definition will not apply for purposes of the limits described above.

Proposed legislation would modify these rules. Under the proposal, elective pretax employee contributions to a defined contribution plan, Section 403(b) plan, Section 457 plan, or cafeteria plan would be included in the definition of compensation for purposes of the limits on contributions and benefits.

Social Security Taxes

Participation by an NEA member in a deferred compensation plan can affect the applicability of Social Security taxes with respect to such member.

The Social Security tax has two components: (1) a tax of 6.2 percent of wages, which is for old-age, survivors, and disability insurance (OASDI), and (2) a tax of 1.45 percent of wages, which is for hospital insurance. Each component applies to both the employer and the employee, so that the total OASDI tax is 12.4 percent of wages and the total hospital insurance tax is 2.9 percent of wages. Solely for purposes of the OASDI tax, no more than $60,600 (indexed) of compensation is treated as wages subject to the tax.

The general rule is that the Social Security tax does not apply to employees of a state or local government. There are, however, exceptions to this general rule. First, a state or local government employee is subject to the Social Security tax if there is in effect with respect to the service performed by such employee an agreement entered into between the state and the Secretary of Health and Human Services pursuant to Section 218 of the Social Security Act. If such an agreement is in existence with respect to an employee, then the remaining portions of this discussion of the applicability of Social Security taxes are not relevant for such an employee.

A second exception to the general rule set forth above applies solely to the HI tax. Very generally, the hospital insurance tax applies to all state or local government employees other than those who were performing "substantial and regular services" for their current employer prior to April 1, 1986.

It is the third exception that relates to deferred compensation plans. Generally, effective July 1, 1991, state or local government employees are subject to the Social Security tax unless they are members of a state or local government "retirement system."

Any of the deferred compensation plans discussed in this report—defined benefit pension plans, defined contribution plans, Section 403(b) plans, SEPs, Section 457(a) plans, and Section 457(f) plans—can qualify as a retirement system if they satisfy the applicable requirements. In general, with respect to an employee of a state or local government, a retirement system must provide benefits that are comparable to the benefits that would be provided, based solely on the employee's service for the state or local government, under the old-age portion of the OASDI program of Social Security. This determination is made on an employee-by-employee basis.

In the case of a deferred compensation plan that has a defined contribution structure, the general "comparability to Social Security" rule described above is interpreted to mean that the allocation to an employee's account must equal at least 7.5 percent of the employee's compensation. (For all purposes under these rules, compensation may be limited to base pay, and compensation in excess of $60,600 (indexed) may be disregarded.) The law allows a deferred compensation plan with a defined benefit structure to satisfy the general "comparability to Social Security" rule in any way, that is, the law does not establish a specific minimum benefit that is required, as in the case of defined contribution structures.

The law does, however, provide certain safe harbor methods of satisfying the general comparability rule. In general, one such safe harbor is a benefit equal to 1.5 percent multiplied by an employee's average compensation for the last three years of service multiplied by years of service. Generally, early retirement subsidies are not taken into account in determining whether plans with a defined benefit structure satisfy the rule. For purposes of both the defined contribution and defined benefit rules, both employer and employee contributions may be taken into account.

In the case of a part-time, seasonal, or temporary employees, a deferred compensation plan does not qualify as a retirement system unless the rules described above are satisfied and the plan provides such employee with a fully vested benefit. Generally, however, the "fully vested" requirement is deemed to be satisfied if, regardless of whether the plan has a defined benefit or a defined contribution structure, the part-time, seasonal, or temporary employees are entitled to a benefit that has a value at least equal to the cumulative amount the employees would be entitled to if they had received the defined contribution minimum for each year of service (that is, 7.5 percent of compensation for each year of service plus interest on such amount. If the plan has a defined benefit structure, the defined benefit rule described above also applies.) Thus, if this 7.5

percent rule is satisfied, it is permissible for additional benefits to be forfeitable.

Of course, to the extent that employees are subject to the Social Security tax, their service is also generally taken into account in determining their eligibility for Social Security and Medicare benefits.

Age Discrimination Rules

In 1990, Congress enacted the Older Workers Benefit Protection Act (OWBPA) in reaction to the Supreme Court's decision in *Public Employees Retirement System of Ohio v. Betts*.

The *Betts* decision provided employers with broad protection against age discrimination suits based on the structure or operation of an employee benefit plan. In *Betts*, the Supreme Court held that an employee benefit plan could be maintained in a manner that discriminated against older employees provided that the plan was not used as a subterfuge to discriminate against older employees with respect to non-plan matters such as hiring and termination of employment.

OWBPA, which amended the Age Discrimination in Employment Act of 1967 (ADEA), overturned the *Betts* decision and also provided a number of specific rules. First, OWBPA provided generally that employee benefits are independently subject to the age discrimination prohibition contained in ADEA. OWBPA went on to provide that discrimination under an employee benefit plan will not be considered to exist where the "actual amount of payment made or cost incurred on behalf of an older worker is no less than that made or incurred on behalf of a younger worker." OWBPA cross-referenced certain regulations that set forth such an equal benefit or equal cost standard and further provided that the employer has the burden of proving an equal benefit or equal cost justification for what would otherwise be discrimination against older workers.

OWBPA also generally permitted other practices without regard to whether they satisfy the equal benefit or equal cost test. Among these practices are (1) voluntary early retirement incentive plans that are consistent with the relevant purposes of ADEA, (2) minimum age requirements for eligibility for normal or early retirement benefits, (3) subsidized early retirement benefits under a deferred compensation plan with a defined benefit structure, and (4) Social Security supplements under a deferred compensation plan with a defined benefit structure (that is, benefits that do not exceed Social Security old-age insurance benefits and that are only payable to retirees before they become eligible for reduced or unreduced Social Security benefits).

OWBPA also generally permits certain benefits to reduce severance pay otherwise payable as the result of a contingent event unrelated to age (such as the closing of a school). Specifically, the benefits that can reduce severance pay are (1) some or, in certain circumstances, all of the retiree health benefits received by an individual eligible for an immediate pension and (2) additional pension benefits made available as a result of a contingent event unrelated to age, following which the individual is eligible for an immediate and unreduced pension benefit.

Under OWBPA, there is no age discrimination solely because benefits under an employer's long-term disability plan are reduced by pension benefits (other than those attributable to employee contributions) that are paid to an individual who has voluntarily elected to receive such pension benefits or payable to an individual who has attained the later of age 62 or normal retirement age under the pension plan and who is eligible for such pension benefits.

The OWBPA rules do not affect the continued application of the ADEA rules adopted in 1986. Very generally, the latter rules provide that benefit accruals or allocations under a deferred compensation plan may not be reduced or eliminated because of attainment of a specified age (such as normal retirement age).

The new OWBPA rules do not apply to a series of benefit payments that began prior to the OWBPA effective date (which was generally October 16, 1992, for state and local governments) and that continued after the effective date without a substantial modification made to evade the purposes of OWBPA.

Finally, OWBPA provides that an individual may not waive any right under ADEA unless the waiver is knowing and voluntary. OWBPA sets out a list of detailed minimum requirements that must be satisfied in order for a waiver to be knowing and voluntary, including a requirement that the waiver not apply to rights or claims that arise after the date of the waiver.

Basic Differences Among Plans

The following chart provides a very general summary of the basic elements of the five types of deferred compensation plans. The information provided in the chart is subject to numerous exceptions that have been discussed above; accordingly, the chart should not be relied upon as the only guidance on any question. Except as otherwise noted below, references to taxation are references to the income tax, as opposed to the Social Security tax.

Elements of Deferred Compensation Plans — General Summary

Element	Defined benefit pension plans (Section 401(a))	Defined contribution plans (Section 401(a))	Section 403(b) plans	SEPs (Section 408(k))	Section 457(a) plans
Plan pays employees retirement benefit based on formula	Yes	No	No	No	No
Plan pays employees the contributions credited to their account, plus actual earnings on those contributions	No	Yes	Yes	Yes	Yes
Trust for plan assets	Yes	Yes	No	Yes	No
No taxation of any person until benefits are distributed	Yes	Yes	Yes	Yes	Yes
Distributions not rolled over are taxed to recipients except to extent of after-tax employee contributions	Yes	Yes	Yes	Yes	Yes
Under Section 414(h), pick-up contributions not taxed to employee	Yes	Yes	No	No	No
Elective pretax employee contributions permitted	No	No	Yes	No	Yes
Elective after-tax employee contributions permitted	Yes	Yes	Yes	No	No
Social Security tax on contribution (if otherwise applicable	No (except employee contributions and pick-up)	No (except employee contributions and pick-up)	Yes	No	Yes
Social Security tax on distribution (if otherwise applicable)	No	No	No	No	No
Distributions permitted prior to termination of employment	No	Yes	Yes	Yes	Yes
Distributions permitted prior to termination of employment or hardship	No	Yes	No	Yes	No
Certain non-annuity distributions before age 59½ subject to 10% penalty tax	Yes	Yes	Yes	Yes	No
Loans from plan to employee permitted, subject to limits	Yes	Yes	Yes	No	NA

Elements of Deferred Compensation Plans — General Summary (cont.)

Element	Defined benefit pension plans (Section 401(a))	Defined contribution plans (Section 401(a))	Section 403(b) plans	SEPs (Section 408(k))	Section 457(a) plans
Annual limit on benefits (Section 415(b))	Lesser or $118,800 (indexed) or employee's 3-year average compensation	NA	NA	NA	NA
Annual limit on contributions (Section 415(c) except in case of 457(a) plan)	NA	Lesser of $30,000 (delayed indexing) of 25% of employee's compensation	Same as defined contribution plans plus additional limitation may apply	Same as defined contribution plans plus additional limitation	Lesser of $7,500 or 33⅓% of employee's compensation
If maintained as supplement to defined benefit pension plan, overall limit on contributions and benefits applicable (Section 415(e))	NA	Yes	No	Yes	No
Limit on elective pretax employee contributions	NA	NA	Higher of $9,500 or $9,240 (indexed)	NA	Same as overall limit above
Rollover of distribution to IRA permitted without taxation	Yes	Yes	Yes	Yes	No
Special lower tax rates applicable to lump-sum distributions (5-year averaging)	Yes	Yes	No	No	No
Nondiscrimination rules applicable prior to 1996/after 1995	No/Yes	No/Yes	No/Yes	Yes/Yes	No/No

HEALTH AND DEPENDENT CARE ASSISTANCE PLANS

Health Plans

Tax Treatment in General

In the NEA 1992 Benefits Survey, 89.6 percent of all respondents participated in a health plan offered by their employer. The survey also indicated that with respect to 95.4 percent of these participants, the employer made at least a partial payment toward the cost of health insurance. The issue then is: What is the tax treatment of such employer payments and of the corresponding health insurance benefit payments?

The general rule is that health insurance coverage provided by an employer to an employee is not taxable to the employee, regardless of whether the employer buys the coverage from a third party (such as a commercial insurer or an HMO) or "self-insures" by paying employees' claims out of its own assets. In addition, the reimbursements or services that the employee receives under the coverage are also not taxable.

The nontaxability of health insurance coverage and of the corresponding reimbursements or services also applies for purposes of the Social Security tax (even if this tax generally applies to an NEA member).

The one significant exception to the general rule of nontaxability is that, under Section 105(h) of the Internal Revenue Code, if a self-insured health plan is discriminatory, "highly compensated individuals" are taxable on at least a portion of the reimbursements provided under the plan.

For purposes of this nondiscrimination rule, a highly compensated individual is generally defined as any employee who is among the top 25 percent of the employer's employees by compensation. Thus, if no NEA member is a highly compensated individual with respect to an employer, the nondiscrimination rule does not have any effect on the NEA members employed by that employer.

Even if one or more NEA members are highly compensated individuals, the nondiscrimination rule may have no effect on a self-insured health plan maintained for NEA members if the health plan is maintained pursuant to a collective bargaining agreement. There are arguments that collectively bargained health plans are or will be made exempt from the nondiscrimination rule.

Health Benefits Trusts

In some cases, it may be desirable for NEA members to have health benefits provided through a trust to which the employer makes contributions. This type of arrangement is most often desirable when the employer is providing health benefits to retired employees. If an employer does not make advance contributions to a trust, there is a risk that the employer will not have sufficient assets to provide retirees with the health benefits that were promised.

If a trust is established, it is, of course, desirable that the trust be exempt from tax. This may be accomplished in three principal ways. First, the employer may establish a voluntary employees' beneficiary association (VEBA). A VEBA is generally a tax-exempt trust that provides certain benefits such as health insurance coverage to employees and/or retired employees. It may be advantageous under certain circumstances for the VEBA to cover NEA members employed by more than one employer. The advantage of such an arrangement is that the cost of group health insurance generally decreases as the number of covered individuals increases. The primary difficulty in creating such an arrangement is coordinating the rights and obligations of the different employers contributing to the VEBA.

The second means of creating a tax-exempt trust to provide health benefits is through the use of a special account within a defined benefit pension plan or money purchase pension plan. This account, referred to as a Section 401(h) account, can only be used to provide health benefits to retirees and their families. In addition, contributions to such an account are generally limited to 25 percent of the total contributions to the pension plan (other than contributions for past service) determined on a cumulative rather than annual basis.

The third means is for the employer to form a separate organization the sole function of which is to receive employer and possibly employee contributions and to provide employee and retiree health benefits. If the employer is a state or a political subdivision of a state, such an organization can be structured to be tax-exempt under Section 115(1) because it is performing essential governmental functions.

Health Care Continuation Rules (COBRA)

State and local governments are, with certain exceptions (generally, the District of Columbia and employers with less than 20 employees), subject to the health care continuation rules, which are commonly referred to as "COBRA." (The name is derived from the Act in which the health care continuation rules were adopted, the "Consolidated Omnibus Budget Reconciliation Act of 1985.") Under COBRA, employees or employees' family members who lose health coverage from the employer due to a "qualifying event" are entitled to continue to receive the coverage ("COBRA coverage") at their own expense (plus an extra 2 percent of the premium cost) for a certain period. That period begins with the qualifying event and generally ends 36 months later.

Qualifying events include the following:

(a) the employee's termination of employment (other than by reason of the employee's gross misconduct) or reduction in hours of employment
(b) the employee's death
(c) the divorce or legal separation of the employee from the employee's spouse
(d) the employee becoming entitled to Medicare benefits
(e) the employee's dependent child ceasing to be a dependent child for purposes of the employer's health coverage

In the case of a qualifying event described in (a), the period of COBRA coverage is generally only 18 months, rather than 36 months. However, generally, under the Revenue Reconciliation Act of 1989, the 18-month period is extended to 29 months in the case of an individual who is determined, under title II or XVI of the Social Security Act, to have been disabled at the time of the qualifying event described in (a). There are also certain other situations in which the period of COBRA coverage varies from the 36-month/18-month rules described above.

There are also events that can cut short an individual's right to COBRA coverage prior to the maximum 36-month/18-month, etc., periods described above. The most common such events are (1) the individual receiving group health coverage from another source *if such coverage does not contain any exclusion or limitation with respect to any* *preexisting condition of such individual* or (2) the individual becoming entitled to Medicare benefits. (The language in italics was added by the Revenue Reconciliation Act of 1989.)

An employer may be obligated, under state law or a collective bargaining agreement, to pay some or all of the cost of the health coverage for an individual following a qualifying event. Generally, the period during which the employer pays for the health coverage counts toward the maximum period during which the employer must offer COBRA coverage. Thus, for example, if an employer provides two months of continued health coverage at no cost to an employee who has terminated employment, such employer is only obligated to offer COBRA coverage at the employee's expense for an additional 16 months.

Retiree Health Benefits

NEA bargaining representatives may wish to bargain for health benefits to be provided to members after their retirement. In this regard, there are a number of points to consider.

First, it should be made clear in the bargaining agreement and in the plan documents that the employer shall not have the power to modify the plan with respect to individuals who have already retired. (Alternatively, the employer should have specific limited powers to modify if that is the result of negotiations.) Employers' ability to modify retirees' health benefits is a constant source of dispute and litigation as employers search for ways to reduce health costs.

Second, NEA bargaining representatives should consider bargaining for a trust to be established to which the employer makes bargained-for contributions. As discussed above, if this does not occur, the employer may not have sufficient assets to provide the bargained-for benefits.

Third, NEA bargaining representatives may wish to consider structuring retiree health benefits so that longer-service members are rewarded with more generous benefits. For example, retirees with less than a certain number of years of service may be required to pay a larger amount to receive retiree health coverage.

Americans with Disabilities Act

The Americans with Disabilities Act (ADA), passed in July 1990 and currently effective for employers with at least 15 employees, generally prohibits disability-based discrimination in the terms, conditions, and privileges of employment. The specific implications of the ADA for employee benefit plans, particularly health plans, remain unclear. A recent notice from the Equal Employment Opportunity Commission (EEOC) provides preliminary guidance on the application of the ADA to health plans, but the ultimate impact on these and other benefit plans will probably be determined by the courts.

In addition to prohibiting direct acts of discrimination, the ADA forbids an employer from participating in any arrangement with a benefit provider that subjects an employee to disability-based discrimination; thus, the ADA applies to an employer's relations with an insurance company, health maintenance organization, or plan administrator. The ADA also forbids an employer from denying benefits to an employee because of a known disability of someone with whom the employee has a known relationship and imposes significant limitations on medical examinations and inquiries by employers.

Section 501(c) of the ADA sets out qualifications to the general rule of the Act that are significant for health plans. That section indicates that (1) an insurer, hospital, or medical service company, health maintenance organization, or any agent, or entity that administers benefit plans, or any similar organizations, may underwrite risks, classify risks, or administer such risks that are based on or not inconsistent with state law; (2) an employer may establish, sponsor, observe, or administer the terms of a bona fide benefit plan that are based on underwriting risks, classifying risks, or administering such risks that are based on or not inconsistent with state law; and (3) an employer may establish, sponsor, observe, or administer the terms of a bona fide benefit plan that is not subject to state insurance laws. Section 501(c) also provides, however, that these qualifications may not be used as a "subterfuge" to evade the ADA.

EEOC regulations provide little guidance on the application of the ADA to employee benefit plans, and courts have only begun to address the issue. However, EEOC Notice N-915.002, issued June 8, 1993, provides the first official interpretation of the interaction of the ADA and employee health plans.

The notice, issued as a directive to EEOC field offices, specifies several consequences of the ADA for health plans: (1) a disability-based distinction in an employee health plan is permissible only if it satisfies Section 501(c) of the ADA; (2) decisions about the employment of a disabled individual cannot be motivated by concerns about the impact of the individual's disability on the employer's health plan; (3) disabled employees must have equal access to the health insurance provided to employees without disabilities; and (4) decisions about the employment of an individual who has a relationship with a disabled person cannot be motivated by concerns about the impact of that person's disability on the employer's health plan.

The EEOC Notice addresses only the first of these in detail. It indicates that if a term in a health plan (whether applicable to an employee or to an employee's dependent) is a "disability-based distinction," the employer must show that the health plan is bona fide and that the challenged term is not a subterfuge to evade the ADA.

According to the notice, a health plan term is a "disability-based distinction" if it singles out a particular disability (such as deafness, AIDS, or schizophrenia), a discrete group of disabilities (such as cancers, muscular dystrophy, or kidney diseases), or disabilities in general. However, health plan provisions that are not based on a disability and that are applied equally to all employees do not violate the ADA—even if those provisions have a disparate impact on employees with disabilities.

Thus, blanket pre-existing condition clauses, universal limits on or exclusions from coverage of all elective surgery or experimental drugs or treatments, coverage limits on medical procedures that are not exclusively (or nearly exclusively) used for the treatment of a particular disability (such as limitations on the number of blood transfusions or X-rays), lower benefit levels for mental or nervous conditions than for physical conditions, and lower benefit levels for health services defined so broadly (such as "eye care") as to apply to the treatment of many dissimilar conditions and to apply to employees with and without disabilities are not disability-based distinctions and do not violate the ADA.

Under the notice, if a health plan term is a disability-based distinction, the employer must demonstrate that the plan is bona fide and that the challenged term is not a subterfuge to evade the ADA. A plan is a bona fide plan if, in the case of an insured plan, it exists, pays benefits, has been communicated to employees, and is consistent with state law or if, in the case of a self-insured plan, it exists, pays benefits, and has been communicated to employees. A "subterfuge" is a disability-based distinction that is not justified by the risks or costs associated with the disability.

Justifications for disability-based distinctions that are not subterfuges include proof (1) that the employer has not engaged in the alleged discrimination; (2) that the distinction is justified by legitimate actuarial data or by actual or reasonably anticipated experience and that conditions with comparable actuarial data or experience are treated in the same fashion; (3) that the distinction is necessary to ensure that the health plan satisfies commonly accepted or legally required standards for fiscal soundness; (4) that the distinction is necessary to prevent an unacceptable change in the coverage of the plan or in the premiums charged for the plan; or (5) in the case of a distinction that denied coverage for a specific treatment, that the treatment has no medical value.

Dependent Care Assistance Programs

In general, dependent care assistance provided by an employer to an employee under a qualified program is not taxable to the employee for purposes of either the income tax or the Social Security tax. This is true regardless of whether the assistance is provided in the form of reimbursement of the employee's dependent care expenses or in the form of a dependent care facility provided by the employer.

Favorable Tax Treatment Limitations and Requirements

In order to qualify for the favorable tax treatment described above, employer-provided dependent care assistance must meet certain requirements. First, the assistance must relate to expenses for the care of dependents of the employee who are either under age 13 or unable to take care of themselves. (The expenses may also be for ordinary household services if performed by the same person caring for the dependent.) Second, such care must enable the employee to work; that is, but for the care that the employees obtain, they would have to give up their work to care for the dependent. Third, except with respect to dependents under age 13, the care generally must either take place in the employee's household or relate to a dependent who lives in the household. Fourth, the care may not be provided at an overnight camp.

Employer-provided dependent care assistance in excess of specified limits is taxable to the employee. The basic limit is $5,000 per year ($2,500 in the case of a married individual filing a separate return). However, if the employee or the employee's spouse earns less than $5,000 (or $2,500) during the year, the limit is reduced to the amount of earnings of the lower-earning spouse. Thus, generally, if an employee's spouse does not work, all employer-provided dependent care assistance is taxable to the employee.

The limit applies to the amount of expenses an employee incurs during a year that are subject to reimbursement, not to the actual reimbursements.

As noted above, employer-provided dependent care assistance must be provided under a qualified program in order to be nontaxable. In order to be qualified, an employer's program must satisfy three nondiscrimination rules. All three of these nondiscrimination rules are based on the definition of highly compensated employees described above.

First, the group of employees eligible for the program must satisfy a complicated set of tests designed to ensure that enough nonhighly compensated employees are eligible. These tests generally should not present a problem for programs maintained for NEA members. Second, benefits under the program must not be available on a basis that favors highly compensated employees over nonhighly compensated employees. If the program for NEA members makes benefits available on the same basis to all eligible employees, this second nondiscrimination rule is satisfied.

The third rule may present a problem for certain NEA members. Under the third rule, the average value of the assistance actually received by the nonhighly compensated employees must be at least 55 percent of the average value of the assistance received by the highly compensated employees. There are certain special rules that can make the test easier to satisfy, but if the test is nevertheless not satisfied, all highly compensated employees are taxable on all employer-provided dependent care assistance that they receive.

Dependent Care Credit

For purposes of evaluating the advantages of establishing a dependent care assistance program, it is important to understand how the dependent care credit works and how the credit interacts with an employer-provided program.

If individuals pay for their own dependent care (rather than have their employer pay for it), the individuals are eligible for a tax credit. The tax credit is generally equal to 20 percent of the dependent care expenses paid by the individual for the year. In order to be eligible for this credit, the expenses themselves must satisfy the requirements described above relating to the definition of dependent care assistance. (For example, the expenses must be incurred in order to enable the individual to work.)

In addition, the expenses eligible for the credit are subject to certain limits. The basic limits are $2,400 for an individual with one dependent being cared for and $4,800 for an individual with two or more dependents. This basic limit is reduced to the level of earnings of the lower-earning spouse (if such spouse earns less than the basic limit). So, again, generally, if one spouse does not work, the credit is not available.

Finally, the rate of the credit is increased for taxpayers with adjusted gross income (AGI) of $18,000 or less. The maximum rate is 30 percent for taxpayers with AGI of $10,000 or less.

For every dollar of dependent care assistance provided by an employer to an employee under a qualified program, the amount of expenses eligible for the credit is reduced by a dollar (but not below zero). For example, assume that an employee with one dependent receives $3,000 of employer-provided dependent care assistance under a qualified program. The limit on expenses eligible for the credit would be reduced from $2,400 to zero. (It is assumed that the lower-earning spouse rule has not already reduced the limit.) If, on the other hand, the employee had two dependents, the limit would be reduced from $4,800 to $1,800. That would mean that the employee could claim a credit of 20 percent (or higher, depending on the employee's AGI) of dependent care expenses up to $1,800.

Forms of Provision

Employer-provided dependent care assistance is almost always provided in one of two forms: a dependent care facility provided by the employer or a "cafeteria plan." The cafeteria plan approach, which is by far the most common, is discussed in the next section of this report, together with a discussion of how an employee should decide whether to use available employer-provided dependent care assistance or the dependent care credit.

Cafeteria Plans

Under proposed IRS regulations, employees who have the choice between cash and a health benefit are treated for tax purposes as if they had received the cash unless the choice is made under a cafeteria plan that is qualified under Section 125 of the Internal Revenue Code. Thus, unless the choice is made under a qualified cafeteria plan, the employees will be taxed on the value of the cash, even if they choose to receive the health benefit instead of the cash. The same rule applies to a choice between cash and dependent care assistance or among cash, a health benefit, and dependent care assistance.

If the choices described above are made pursuant to a qualified cafeteria plan, the employees who choose a health benefit or dependent care assistance are not treated as receiving the cash they could have chosen. Moreover, the health benefit or dependent care assistance chosen by an employee is treated as if it were provided by the employer and thus is nontaxable to the extent described above.

Examples

No cafeteria plan

Assume that an employee has a salary of $30,000. The employee's employer provides family health insurance to the employee, but only if the employee agrees to pay $1,000 of the $4,000 cost of such insurance. The health insurance does not provide coverage for dental or vision expenses, has a $250 deductible, and requires a 20 percent copayment by the employee up to a specified level.

Assume further that the employee agrees to pay the $1,000 for the health insurance. During the year, the employee incurs $500 of health expenses that are not reimbursable under the insurance policy, either because they were not covered (such as dental expenses) or because they were subject to the deductible or copayment rules. In addition, the employee pays $2,000 for dependent care expenses.

The employee in this example will receive a Form W-2 from the employer showing $30,000 as wages subject to income and Social Security tax (if applicable). The employee will be entitled to a dependent care credit equal to 20 percent (assuming his/her AGI exceeds $18,000) of $2,000, for a credit of $400. It is assumed that the employee's $1,500 of health expenses ($1,000 for the insurance and $500 for other expenses) do not exceed 7.5 percent of his/her AGI, so that no part of the health expenses is deductible under Section 213 of the Internal Revenue Code.

Cafeteria plan established

Assume the same facts except that the employer also establishes a qualified cafeteria plan that allows employees to choose health benefits and/or dependent care assistance in lieu of a part of salary. This enables the employees to make three elections prior to the beginning of the plan year. First, the employees could elect to give up $1,000 of salary in exchange for the employer using that $1,000 to pay the employees' share of the cost of the health insurance. This aspect of the cafeteria plan is often referred to as "premium conversion." Second, the employees could elect to forgo an additional $500 of salary in exchange for the employer using that amount to reimburse them for the $500 of uninsured health expenses that they anticipate having. This election would be made under a part of the cafeteria plan called a "health flexible spending arrangement" or "health FSA."[16] Third, under a "dependent care flexible spending arrangement" or "dependent care FSA," the employees could elect to give up another $2,000 of salary in exchange for the employer using that $2,000 to reimburse them for the $2,000 of dependent care expenses that they anticipate having.

If the employees make these three elections, they will receive Form W-2s from the employer showing only $26,500 as wages subject to income tax and Social Security tax (if applicable)—$30,000 - $1,000 - $500 - $2,000 = $26,500. The reduction of their wages by $3,500 from $30,000 to $26,500 will save them income taxes of $3,500 x .15 = $525 if they are in the 15 percent income tax bracket ($980 if they are in the 28 percent income tax bracket). If Social Security taxes apply, the reduction will save them an additional .0765 x $3,500 = $267.75. Thus, if Social Security taxes apply, their tax savings under the cafeteria plan are $525 + $267.75 = $792.75 if they are in the 15 percent tax bracket. This $792.75 is almost double the $400 tax credit, which is the only tax savings that they lost by participating in the cafeteria plan.

[16] *A health FSA is considered a self-insured health plan subject to the nondiscrimination rule of Section 105(h) of the Internal Revenue Code.*

A few facts regarding health insurance coverage of NEA members may help put the above example into perspective. According to the NEA 1992 Benefits Survey, 49.9 percent of respondents participating in an individual health plan and 58.3 percent of respondents participating in a family health plan contribute part of the premium for such plan. Among such contributors, the average annual employee premium contribution was $1,080 and $1,488, respectively.

With respect to uninsured health expenses—the $500 figure in the above example—the NEA 1992 Benefits Survey showed that at least 37.1 percent of the respondents did not have coverage for vision care, at least 12.6 percent did not have dental coverage, and at least 9.3 percent did not have coverage for prescription drugs. Moreover, although the survey did not ask for data regarding deductibles, coinsurance, and copayments, it is likely that these are being increased as employers generally seek to shift a greater portion of rising health costs onto employees.

Qualified Cafeteria Plan

In order to be qualified, a cafeteria plan must generally satisfy certain requirements. The following are the most significant of these requirements: (1)employee election rule; (2)"use-it-or-lose-it" rule; (3)"employer-risk-of-loss" rule and (4)"no deferred compensation" rule. Although nondiscrimination rules generally must also be satisfied, collectively bargained plans for NEA members are generally exempt from these rules.

Employee election rule

In general, employees must make their elections under a cafeteria plan prior to the beginning of the year. Thus, in the example described above, the employees must predict the amount of uninsured health expenses that they will have during the year. If their prediction is too low (for example, if they elect $500 and actually have $750 of expenses), they have lost the opportunity to reduce their taxable salary by the excess ($250 in this example). In other words, the cafeteria plan still provides them tax savings but not as much as it could have. If their prediction is too high, they are subject to the "use-it-or-lose-it" rule described below, which has a more adverse effect.

The requirement that elections must be made prior to the beginning of the year is mitigated to some extent by a rule that allows cafeteria plans to allow employees to change their elections prospectively if during the year they have a "change in family status." The following are examples of changes in family status drawn directly from the IRS regulations: the marriage or divorce of the employee, the death of the employee's spouse or a dependent, the birth or adoption of a child of the employee, the termination of employment (or commencement of employment) of the employee's spouse, the switching from part-time to full-time employment status or from full-time to part-time status by the employee or the employee's spouse, and the taking of an unpaid leave of absence by the employee or the employee's spouse. Another example is a significant change in the health coverage of the employee or spouse attributable to the spouse's employment.

As noted above, election changes permitted upon a change in family status must be prospective only. In other words, an employee may only change the amount of salary forgone after the change in family status occurs. For example, assume the same facts described above, that is, that an employee elects to forgo $500 of salary in exchange for that amount being available for uninsured health expense reimbursement. A portion of the $500 is to be taken out of each paycheck on a pro rata basis. After six months, the employee becomes divorced and wishes to reduce the election to zero. He/she can stop any further reduction of salary, but cannot change the election with respect to the $250 (6/12 of $500) by which salary has already been reduced. With respect to the effect of this inability to change an election retroactively, see the discussion of the use-it-or-lose-it rule below.

Also, a change in election that is made following a change in family status must be consistent with the change in family status. For example, following the birth of a child, it might be consistent to increase one's election for dependent care assistance.

Finally, certain election changes are permitted if the premiums for the health insurance elected by the employee change or the coverage is significantly modified during the year. For instance, in the example described above, if the cost of the health insurance rose 10 percent, the employees' election to forgo $1,000 could be adjusted automatically to cover their share of the extra cost. These rules only apply, however, if the employer purchases the health insurance from an independent third party such as an insurance company or an HMO.

The use-it-or-lose-it rule

Under the use-it-or-lose-it rule, if employees elect to forgo salary in favor of a specified benefit, the forgone salary may only be used for that benefit. For example, assume the facts in the example above. Assume further that the employees incur no uninsured health expenses during the year. In such a case, they simply lose the $500 of salary that they gave up in exchange for the employer agreeing to reimburse them for up to $500 of uninsured health expenses. The $500 may not be carried forward and be available to them in the next year.

Employees' losses under the use-it-or-lose-it rule are forfeited to the employer. NEA representatives should bargain to obligate the employer to return the losses to the employees. Under the cafeteria plan rules, the employer may return the employees' losses to the employees as a group on, for example, a per capita basis or based on the amount of each employee's election, but not based on the amount of each employee's loss.

The employer-risk-of-loss rule

The employer-risk-of-loss rule is a controversial proposed rule that only affects health FSAs. Under this rule, employees are entitled to reimbursement of the full amount of their annual election even if they have not yet forgone that amount of salary.

Assume the same facts in the example above. After 3 months, an employee has only forgone \$125 of salary (3/12 of \$500) with respect to uninsured health expenses. However, if the employee were to incur a \$500 uninsured health expense at that time, the employer would have to make immediate payment of the full \$500.

Employers will clearly be concerned about their risk of loss under this rule; the employee in the above example might quit or change elections after receiving the \$500. There are numerous ways for an employer to reduce this risk, but no way to eliminate or even substantially eliminate it.

The no-deferred-compensation rule

A qualified cafeteria plan generally may not be used to provide an employee with a benefit in a later year. For example, employees may not reduce their salary in the current year in exchange for a benefit in the subsequent year. This prohibition does not, however, apply to employee contributions to a defined contribution plan (or in certain cases to a defined benefit pension plan), employer matching contributions to a defined contribution plan, certain group-term life insurance, and reasonable premium rebates or policy dividends paid within 12 months of the end of the year.

Disadvantages of a Cafeteria Plan

The employee election rule and the use-it-or-lose-it rule are negative aspects of a cafeteria plan from an employee's perspective. The following are additional disadvantages.

Social Security

When employees forgo salary under a cafeteria plan, they are reducing their wages for purposes of Social Security benefits (assuming Social Security applies to them).

Employer cost saving

Cafeteria plans can, in certain situations (such as in the example above), be advantageous for employees. In other situations, employers can use cafeteria plans to shift more of the cost of health insurance to employees.

For example, assume that an employer provides health insurance costing \$4,000 to every employee without requiring any employee to pay any part of the cost. Such an employer might modify its arrangement as follows. The employer simultaneously (1) provides all employees with a

$4,000 employer "credit" that is in effect like a salary increase of $4,000, (2) requires employees who desire health insurance to pay the full cost of such insurance, and (3) establishes a cafeteria plan. Under the cafeteria plan, the employees can either take the $4,000 in cash or forego it if they want health insurance. Thus, in the first year in which these modifications are effective, the employees have not suffered any financial detriment. The next year, however, when the cost of the health insurance rises to, for example, $4,500, the employer may decide that the amount of the credit will remain at $4,000. Employees who wish to receive health insurance must forego an additional $500 of salary to receive the health insurance. The employer has thus shifted the burden of the increased cost of the health insurance to the employees.

Another effect of these types of elective arrangements is that they tempt lower-paid employees to take cash instead of health insurance.

Dependent care credit

In certain circumstances, it will be advantageous for an employee to use the dependent care credit rather than using the cafeteria plan to obtain dependent care assistance.

In general, the value of using the dependent care assistance is the sum of (1) the individual's income tax bracket times the amount of dependent care expenses (up to the limit), plus (2) if applicable, 7.65 percent (the Social Security tax rate)[17] of these expenses. For an individual in the 15 percent bracket, this means the benefit is 15 percent of the expenses if Social Security does not apply or 22.65 percent if Social Security applies. The value of the credit ranges meanwhile from 20 percent to 30 percent of the expenses. Accordingly, for example, with respect to an individual in the 15 percent income tax bracket who is not subject to Social Security, use of the credit may be advantageous.

The above analysis does not take into account the use-it-or-lose-it rule, the loss of Social Security benefits connected with the use of the cafeteria plan, or the effect of the use of the cafeteria plan on other federal tax provisions such as the earned income credit (which is affected because use of the exclusion reduces AGI and thus can increase the available earned income credit). Another relevant factor is the higher limit available with regard to dependent care assistance. For example, an employee with one dependent and $5,000 of dependent care expenses effectively has a choice between a credit on expenses of $2,400, or dependent care assistance of $5,000.

Other Uses of Cafeteria Plans

Cafeteria plans may also be used by employees with respect to group-term life insurance (including postretirement life insurance under an exception to the no-deferred-compensation rule).

[17] *If only the hospital insurance tax applies, the figure is 1.45 percent, rather than 7.65 percent.*

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